# Petition

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No. 81-839

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

JERALD H. SKLAR, *et al.*,
*Petitioners,*

v.

JAMES L. SHORES, JR., Executor of the Estate of Clarence E. Bishop, Jr.,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

CRAWFORD S. McGIVAREN, JR.
LARRY BRITTAIN CHILDS
CABANISS, JOHNSTON, GARDNER, DUMAS & O'NEAL
1900 First National-Southern Natural Building
Birmingham, Alabama 35203
(205) 252-8800

*Attorneys for Petitioners Jerald H. Sklar, Allen Cox, Jr., Roane Waring, Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr.*

*(Additional Attorneys Listed Inside Front Cover)*

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HOBART A. MCWHORTER, JR.
SAMUEL H. FRANKLIN
BRADLEY, ARANT, ROSE
& WHITE
1400 Park Place Tower
Birmingham, Alabama 35203
(205) 252-4500
*Attorneys for Petitioner Capell, Howard, Knabe & Cobbs, P.C.*

HENRY E. SIMPSON
LANGE, SIMPSON, ROBINSON
& SOMERVILLE
1700 First Alabama Bank Building
Birmingham, Alabama 35203
(205) 252-7000
*Attorney for Petitioner First Alabama Bank of Phenix City, N. A.*

JAMES L. NORTH
NORTH, HASKELL, SLAUGHTER,
YOUNG & LEWIS
1710 First National - Southern
Natural Building
Birmingham, Alabama 35203
(205) 252-8847
*Attorneys for Petitioners Cecil Lamberson and Jackson Municipals, Inc.*

## QUESTIONS PRESENTED

1. Is reliance an essential element for recovery under Rule 10b-5?

2. Can a plaintiff who purchased securities solely upon the oral representations of a non-party, and who admittedly was not deceived by any actions or representations of defendants recover under Rule 10b-5?

3. Do the same fundamental elements of fraud govern recovery under Section 10(b) regardless of whether the securitiy in question was "entitled to be marketed"?

## PARTIES BELOW

Parties in the Court of Appeals were appellant James L. Shores, Jr., Executor of the Estate of Clarence E. Bishop, Jr.; and appellees Jerald H. Sklar, Allen Cox, Jr., Roane Waring, Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr., a partnership engaged in the practice of law as Waring, Cox, James, Sklar & Allen; Capell, Howard, Knabe & Cobbs, P.C., a professional association engaged in practicing law; First Alabama Bank of Phenix City, N.A., a national banking association; Cecil J. Lamberson; Jackson Municipals, Inc., a corporation; George C. Rakerd; Asa G. Candler V; John H. Candler, Jr.; Thomas E. Martin, Jr.; Robin B. Page; Joseph F. Savage, III; Jerry B. Yokley; Investors Associates of America, Inc.; and Clarence H. Hamilton, Jr.

First Alabama Bank of Phenix City, N.A., is a subsidiary of First Alabama Bancshares, Inc.

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners Jerald H. Sklar, Allen Cox, Jr., Roane Waring Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr., a partnership engaged in the practice of law as Waring, Cox, James, Sklar & Allen; Capell, Howard, Knabe & Cobbs, P.C., a professional association engaged in practicing law; First Alabama Bank of Phenix City, N.A., a national banking association; Cecil Lamberson; and Jackson Municipals, Inc. pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit.

### OPINIONS BELOW

The *en banc* opinion of the United States Court of Appeals for the Fifth Circuit, reported at 647 F.2d 462, is printed as Appendix A. The unreported opinion of the United States District Court for the Northern District of Alabama is printed as Appendix B.

## JURISDICTION

The judgment of the Court of Appeals was entered May 26, 1981. Appendix C. The timely petition for rehearing of petitioners Sklar, Cox, Waring, James, Allen and Watson was denied by the court on August 3, 1981. Appendix D. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## STATUTES INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, are set forth in Appendix E.

## STATEMENT OF THE CASE

Petitioners are two law firms, a national banking associaton, and an investment banking company. Jerald H. Sklar, a member of the firm of Waring, Cox, James, Sklar & Allen, and John Andrews, a lawyer with Capell, Howard, Knabe & Cobbs, P. C., were bond counsel for the subject bond issue. The First Alabama Bank of Phenix City, N.A., was trustee for the issue. Jackson Municipals, Inc., with which Cecil Lamberson was associated, was the underwriter.

In January, 1973, plaintiff, Clarence E. Bishop, Jr.,[1] purchased four newly issued, tax-exempt industrial development revenue bonds from his broker in face to face transactions.

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[1] After filing suit Bishop died. His executor, James L. Shores, Jr., was substituted as plaintiff by the district court.

(App. B-4, B-6)[2] The Proceeds of the bond issue were used to finance construction of a mobile home manufacturing plant in Frisco City, Alabama. The plant was owned by the Industrial Development Board of that City and leased to a private company. After construction and after the plant was in operation, the lessee defaulted in rental payments in April, 1974, and the bonds went into default. The trustee of the bond issue foreclosed, and bondholders ultimately received $373.33 per $1000 bond. (App. A-2, n. 1).

Following the default, Bishop sued, among other defendants, bond counsel, the underwriter, the certified public accountant, and the trustee of the bond issue, invoking the district court's jurisdiction under section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa (1976). Bishop's Second Amended Complaint, which was filed after extensive discovery, alleged two claims under Rule 10b-5:

> (1) that the bonds were sold by means of an Offering Circular that contained material misrepresentations and omissions, and
>
> (2) that defendants engaged in a conspiracy to sell the bonds by means of the allegedly misleading Circular.

Thus, the sole manifestation of the claimed fraud was the allegedly misleading Offering Circular.

In answers to interrogatories, Bishop admitted that he had never seen and was not even aware of the existence of the Offering Circular. Bishop also admitted that he purchased the bonds solely upon oral representations by his broker that "these were

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[2] The bonds were exempt from the registration requirements of the Securities and Exchange Commisson by virtue of section 3(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (1976).

tax-free bonds and a good investment." (App. B-8.)[3] In the trial court Bishop steadfastly refused to allege any form of reliance. Therefore, the district court entered summary judgment in favor of defendants, holding that some element of reliance is essential to a Rule 10b-5 action.

On appeal, the Court of Appeals sitting *en banc* reversed by a vote of 12 to 10.[4] The majority held that reliance is not required if a purchaser can prove that a security is "not entitled to be marketed." The majority opinion acknowledged that "[t]o the extent that Bishop pleaded the usual 10b-5 misrepresentation or omission case, the district court was correct. Reliance is an essential element of such a cause of action, though the burden of proving or disproving reliance may shift depending on the nature of the case." (App. A-10.)[5] The court concluded that

> Bishop alleged that the Offering Circular contained material misrepresentations and failed to state material facts necessary to make the statements made not misleading. At the same time, he admitted that he never read or otherwise relied on the Offering Circular. If the *Ute* presumption applies to these nondisclosures, Bishop's admission rebuts it. Bishop's claim that he was deceived by

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[3] The broker was not made a defendant to Bishop's 10b-5 action. Bishop never claimed that his broker had even seen the Offering Circular.

[4] Three judges of the court did not participate in the decision.

[5] Referring to *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1978), the court observed that "*Ute* did not eliminate reliance as an element of a 10b-5 omission case; it merely established a presumption that made it possible for the plaintiff to meet their burden. When the *Ute* presumption attaches, the defendant may rebut it by showing that the plaintiff did not rely on the defendant's duty to disclose." (App. A-10.)

> the misrepresentations and omissons of the Offering Circular was correctly dismissed by the district court because of his failure to read or even seek to read the Offering Circular.

(App. A-11.)

Nevertheless, the court held that even with his admitted non-reliance, Bishop could recover under Rule 10b-5 if he could prove that the bonds in question were "not entitled to be marketed." (App. A-14.) The majority reasoned that purchasers are entitled to rely on the integrity of the market to furnish them securities that are "entitled to be marketed." (App. A-16.)

In a vigorous dissenting opinion, authored by Judge Carolyn Randall, ten circuit judges[6] challenged the majority's holding. The dissent expressed profound concern that

(1) the majority's novel holding[7] was contrary to Fifth Circuit precedent, squarely in conflict with an Eighth Circuit holding, and inconsistent with recent decisions by this Court in the securities field;

(2) The majority's holding turned on an improper distinction based upon whether the securities in question were "entitled to be marketed;"

(3) the majority's holding actually tends to defeat the primary objective of Rule 10b-5—promoting informed investment decisions;

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[6] Joining Judge Randall in dissent were Judges John Brown, Paul Roney, Thomas Gee, Gerald Tjoflat, James Hill, Peter Fay, Alvin Rubin, Thomas Reavley and Joseph Hatchett.

[7] The dissent demonstrated that this case finds "absolutely no support" in the "fraud on the market" cases to which the majority attempted to draw analogy. (App. A-31 - A-34.)

(4) the majority's holding has great potential for increasing the volume of litigation under Rule 10b-5 by providing a federal forum for those plaintiffs who by their own actions would otherwise have forfeited any claim to protection under the Rule; and

(5) the majority's holding has great potential for protracting much 10b-5 litigation that would otherwise be terminated at the summary judgment stage.

## REASONS FOR GRANTING THE WRIT

The novel holding of the court below expands the scope of Rule 10b-5 far beyond any previous authority. The decision eviscerates reliance, a fundamental element of common law fraud, and creates a new substantive entitlement—that purchasers are entitled to rely on the very fact that securities are being sold as assurance that they are of "market risk" quality. Thus, under the aegis of laws enacted to promote full disclosure and foster informed investment decisions, the court below announced a rule that will permit recovery by purchasers who were utterly indifferent to the underwriters' disclosures, and who, the court suggests, may instruct their brokers indiscriminately to purchase any security on the market.

The Court of Appeals' opinion permits recovery by plaintiffs who were not deceived and, accordingly, were not defrauded. The holding transforms the emphasis of Rule 10b-5 from an antifraud statute to an insurance scheme. Such construction of the Securities Exchange Act of 1934 raises serious questions of judicial usurpation of the legislative function of Congress.

The decision by the court below will have significant impact upon the securities industry, banks, lawyers, accountants and other professionals who service it, as well as the federal courts and, indeed, upon the rules that govern Rule 10b-5 actions.

### I. The Questions Presented Involve A Conflict Among The Courts Of Appeal

As the dissent observed, the court's holding "squarely conflicts with the decison of the Eighth Circuit in *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978)." (App. A-30 — A-31.) The facts of *Vervaecke* are virtually identical to the facts of this case: Vervaecke, like Bishop, claimed that an offering circular for bonds contained misrepresentations and material omissions, in violation of Rule 10b-5. Like Bishop, Vervaecke could not and did not allege reliance because he had

not seen the offering circular prior to his purchase. The Eighth Circuit affirmed a summary judgment of dismissal, holding that the absence of reliance was fatal to plaintiff's Rule 10b-5 claim. The Court expressly rejected Vervaecke's argument that his attempt to cast his complaint under subsections (1) and (3) of the rule excused the reliance requirement.

That the Fifth Circuit and Eighth Circuit reached opposite conclusions on virtually identical facts demonstrates irreconcilable conflict between the courts of appeal on the questions presented by this petition.

Subject only to the *Ute* presumption, which the circuit court below found rebutted, other courts of appeal have reaffirmed recently that reliance is essential to recovery under Rule 10b-5. *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) ("Because we find that [plaintiff] has failed to demonstrate his reliance on any actions by appellees, we need not reach the other elements of his 10b-5 claim"); *Sharp* v. *Coopers & Lybrand*, [Current] Fed. Sec.L. Rep. ¶ 97,970 (3d Cir. April 28, 1981) ("Reliance is an element of a plaintiff's action for damages under Rule 10b-5").[8]

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[8] Ironically, less than three months before the *en banc* opinion was announced, a panel of the Fifth Circuit itself had held that "reliance is an issue in *all* Rule 10b-5 cases", *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981) (Judge Rubin), *petition for cert. filed October 9, 1981* (No. 81-680).

This conflict among the circuits is truly signficant. As evidenced by the many scholarly articles written about the reliance requirement,[9] this issue goes to the very heart of the implied right of action under Rule 10b-5.

As a result of the conflicting application of the reliance requirement, purchasers and sellers of securities will be subject to disparate treatment in the different circuits. Whether a purchaser who did not rely upon defendants' representations in making his investment decision can maintain a 10b-5 action will depend upon which circuit's law is applicable. In a time when multi-state securities offerings are commonplace, such uneven application of the law is unjustifiable and may well have a deterrent effect upon those seeking to raise investment capital through nation-wide offerings.

## II. The Lower Court's Expansion Of The Rule 10b-5 Implied Remedy Is Contrary To The Principle Of *Santa Fe Industries, Inc.* v. *Green* And Inconsistent With The Principles Of Construction Established By This Court

The Court of Appeals' expansion of Rule 10b-5 finds no support in the statute, legislative history, the common-law of fraud, or prior case precedent. This judicial legislation contravenes this Court's careful instructions in a variety of recent decisions.

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[9] *E.g.* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975); Stoll, *Reliance as an Element of 10b-5 Actions*, 53 OREG. L. REV. 169 (1974); Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398, 1418-1423 (1974); Dooley, *Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 837-843 (1972).

In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977) (White, J.), this Court held that the language of § 10(b) and, thus, Rule 10b-5 is limited to "manipulation"[10] and "deception." Accepting the lower court's finding that plaintiffs were not deceived by the defendants' actions, the Court held that they consequently could not recover under Rule 10b-5. The Court explicitly rejected plaintiffs' contention that § 10(b) allowed recovery by virtue of a "fraudulent appraisal" that plaintiffs alleged was a "device, scheme or artifice to defraud" or an "act, practice or course of business which operate[d] as a fraud or deceit." 430 U.S. at 474, n. 14. The holding of the circuit court below that Bishop can state a cause of action without alleging that the defendants deceived him in making his investment decision is manifestly contrary to the *Santa Fe* principle.[11]

The Fifth Circuit's unprecedented expansion of the judicially implied remedy under Rule 10b-5 also violates the teachings of other recent opinions of this Court. *Touche Ross & Co.* v. *Redington,* 442 U.S. 560 (1978), emphasized that in construing implied remedies the central inquiry must be Congressional intent. Here the Court of Appeals ignored legislative history demonstrating that Congress intended that only purchasers who rely upon defendants' statements could recover damages under

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[10] *Santa Fe,* like this case, involved no allegations of "manipulation," which is "virtually a term of art when used in connection with securities markets." 430 U.S. at 476-77.

[11] As this case illustrates, reliance is the single element of fraud which establishes the deception of plaintiff.

the Securities Exchange Act [12] The Fifth Circuit's result is an anomaly, which, as decried in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 736 (1975), would expand the "judicially implied cause of action beyond the bounds [Congress] delineated for comparable express causes of action" in the Act. *Compare* Section 18 of the Act, 15 U.S.C. § 78r (1976).

Similarly, the decision in this case cannot be squared with this Court's instructions that federal courts should not "judicially creat[e] a damages action . . . [where it] is unnecessary to ensure the fulfillment of Congress' purposes in adopting the . . . Act." *Piper* v. *Chris-Craft Industries, Inc.,* 430 U.S. 1, 41 (1977) (Burger, C.J.). As the ten judge dissent observed, the result in this action defeats the primary objective of the Rule—the making of informed investment decisions. (App. A-42).[13] This case demonstrates the wisdom of this Court's admonition that "the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 at 214, n.33 (1976).

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[12] The Senate committee report on the 1934 Act stated:

> 8. Civil Liabilities
>
> ...[T]he bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, *and that he relied thereon to his damage.*

S. Rep. 792, 73d Cong., 2d Sess. 12-13 (1934) (emphasis added).

[13] Judge John Minor Wisdom commented in *Dupuy* v. *Dupuy,* 551 F.2d 1005, 1016 (5th Cir.) *cert. denied,* 434 U.S. 911 (1977) that eliminating the reliance requirement would abandon the Congressional purpose of restricting recovery to *victims* of securities fraud:

Finally, in eliminating the common law requirement of "reasonable reliance," the court below apparently ignored the many recent expressions by this Court of the historic relationship of Rule 10b-5 to the "tort of misrepresentation and deceit." *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 744 (1975) (Rehnquist, J.); *Chiarella* v. *United States,* 445 U.S. 222, 227-28 (1980) (Powell, J.) ("At common law, misrepresentation for the purpose of inducing reliance upon the false statement is fraudulent."); *Aaron* v. *Securities and Exchange Commission,* 446 U.S. 680, 709 (1980) (Blackmun, J. dissenting) ("On prior occasions, the Court has emphasized the relevance of common-law principles in the interpretation of the antifraud provisions of the securities laws.") Adherence to the fundamental elements of common law fraud is critical to the stability of the rule 10b-5 private action; without these time-tested standards as a reference the courts are left to interpret this judge-created remedy almost entirely on an *ad hoc* basis.

## III. The Court's Distinction Based Upon The Quality Of The Security Directly Conflicts With Congressional Policy That The Federal Securities Laws Should Not Lead Purchasers To Expect Any Guarantee Of Quality

The court below allows recovery under a new distinction between securities "entitled to be marketed" and those "not entitled to be marketed." In declaring that purchasers are entitled

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[T]o abandon completely the consideration of reliance in fact and reasonable reliance ignores not only the above policies of due diligence but also the need for a causal link between the misrepresentation or omission and the injury suffered by the private plaintiff. The cause of action would no longer provide compensation for losses occasioned by the violation of the Act because a plaintiff could sue without relying on the fraud. This would transform the action into an enforcement mechanism. We reject this approach because of the Supreme Court's recognition of a 10b-5 private action as a device to compensate victims of stock fraud and thereby to promote the public objectives of the Act. J. I. Case Co. v. Borak, 377 U.S. at 432-35, 84 S.Ct. 1555.

to rely on the integrity of the securities market to produce securities that are "entitled are to be marketed," the Court of Appeals effectively legislated a substantive guarantee to purchasers that all securities will meet a minimum threshhold of quality.[14] The new distinction unnecessarily injects the courts into a *qualitative* evaluation of the merits of securities. Such a result is directly contrary to express Congressional intent and decades of government policy. In enacting the 1933 and 1934 securities acts, Congress explicitly rejected the suggestion that the government should attempt in any fashion to evaluate the merits of securities offered for sale. The House Committee Report on the Securities Act stated Congressional intent in capital letters:

> THE NONASSUMPTION BY THE FEDERAL GOVERNMENT OF ANY GUARANTEE
>
> The mechanism devised by your committee for compelling disclosures and for insisting that disclosures shall be both adequate and true has been carefully framed, so that neither action nor nonaction by the Federal Trade Commission can be interpreted as a guarantee or approval of any particular security issued. The right to sell a security follows automatically upon the termination of the stipulated period after the filing of the registration statement.

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[14] This is tantamount to making the professional persons involved in the issuance of securities insurers that the securities are "entitled to be marketed."

H.R. Rep. No. 85, 73d Cong, 1st Sess. 4 (1933).[13] Congress carried forward the same intent in enacting the Securities Exchange Act in 1934: The Senate Committee reported:

> "10. No Official Approval of the Value of Securities
>
> "As pointed out above, there is no intention whatsoever to permit the Commission to direct the flow of credit or to determine what securities shall be issued or sold. On the contrary, it is expressly provided that no action, or failure to act, by the Commission as to any security or transaction shall be construed as an approval of the security or the transaction in question, and it is made unlawful to represent to any prospective purchaser or seller that any such action or failure to act by the Commission is subject to such a construction.

S. Rep. 792, 73d Cong., 2d Sess. 13 (1934).

The majority's departure from the most basic principles of federal securities law is a "harbinger of difficulties for future securities litigation." (App. A-49) (dissent). The importance of this decision and the direct conflict among the circuits warrant the attention of this Court to the questions here presented.

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[13] The Senate Committee Report was equally pointed:

> It has been deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security. Moreover, care has been taken to prevent the public from being led to believe that the Federal Government under the proposed law passes upon the soundness of any security, and to represent that any security has been so approved as to its soundness is declared to be unlawful (sec. 10).

S. Rep. No. 47, 73d Cong. 1st Sess. 2 (1933).

## CONCLUSION

The petition for a writ of certiorari should be granted.

CRAWFORD S. McGIVAREN, JR.
LARRY BRITTAIN CHILDS
Cabaniss, Johnston, Gardner,
Dumas & O'Neal
1900 First National-Southern
Natural Building
Birmingham, Alabam 35203

Attorneys for Petitioners Jerald H. Sklar, Allen Cox, Jr., Roane Waring, Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr.

HOBART A. McWHORTER, JR.
SAMUEL H. FRANKLIN
Bradley, Arant, Rose & White
1400 Park Place Tower
Birmingham, Alabama 35203

Attorneys for Petitioner Capell, Howard, Knabe & Cobbs, P.C.

HENRY E. SIMPSON
Lange, Simpson, Robinson
& Somerville
1700 First Alabama Bank Bldg.
Birmingham, Alabama 35203

Attorney for Petitioner First
Alabama Bank of Phenix City, N.A.

JAMES L. NORTH
North, Haskell, Slaughter,
Young & Lewis
1710 First National - Southern
Natural Building
Birmingham, Alabama 35203
(205) 252-8847

Attorneys for Petitioners Cecil
Lamberson and Jackson Municipals,
Inc.

November, 1981

# Appendix

## APPENDIX A

James L. Shores, Jr., as Executor of
The Estate of Clarence E. Bishop, Jr.,
etc., et al., Plaintiffs-Appellants,

v.

Jerald H. Sklar et al.,
Defendants-Appellees.

No. 77-2896.

United States Court of Appeals,
Fifth Circuit.

May 26, 1981.

Appeal from the United States District Court for the Northern District of Alabama.

Before BROWN, COLEMAN, AINSWORTH, CHARLES CLARK, RONEY, GEE, TJOFLAT, HILL, FAY, RUBIN, KRAVITCH, FRANK M. JOHNSON, Jr., GARZA, HENDERSON, REAVLEY, POLITZ, HATCHETT, ANDERSON, RANDALL, TATE, SAM D. JOHNSON, and THOMAS A. CLARK, Circuit Judges.*

CHARLES CLARK, Circuit Judge:

Clarence E. Bishop, Jr., was one of a number of purchasers of First Mortgage Revenue Bonds of the Industrial Development Board of Frisco City, Alabama ["Bonds"]. The lessee of the industrial business premises, the sole source of the income

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* Chief Judge Godbold and Judge Vance were disqualified in this case. Judge Williams does not wish to participate in the decision.

necessary to amortize the revenue Bonds, almost immediately defaulted in the payment of rent, causing the value of the Bonds to drop precipitously.[1] Bishop sued most of those involved with the issuance of the Bonds, alleging that he was the victim of a pervasive scheme to defraud members of the investing public in violation of the securities laws. In essence, the complaint alleged that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development Board ["Board"] to issue, and the public to buy, fraudulently marketed bonds.[2]

After twice allowing Bishop to amend his complaint, the district court entered summary judgment for the defendants. Based on Bishop's statement in his answers to interrogatories that he never saw nor was he aware of the Offering Circular when he decided to purchase the Bonds, the district court concluded that Bishop had in no way relied on the Circular's alleged misrepresentations or omissions and that his lack of reliance was fatal to his claim. We reheard this case en banc to determine whether a plaintiff must rely specifically on material misrepresentations or omissions in a single disclosure document when, in addition to charges based on its untrue statements or misleading omissions, other allegations would admit proof that the existence of the security in the marketplace resulted from the successful perpetration of a fraud on the investment community and that he purchased in reliance on the market. We hold the securities laws and regulations have a purpose broader than

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[1] After the sale of the lessee's plant, the identifiable Bond holders received $373.33 per $1000 bond.

[2] Throughout the opinion we refer to these Bonds as being "fraudulently marketed." This means the fraudulent scheme alleged by Bishop was so pervasive that without it the issuer would not have issued, the dealer could not have dealt in, and the buyer could not have bought these Bonds, because they would not have been offered on the market at any price.

merely criticizing ever-lengthening, complex prospectuses. They cover deliberate, manipulative schemes to defraud which can annul not only the purpose of disclosure but also the market's honest function. Since plaintiff's pleadings would permit such proof, his suit should not have been dismissed at this initial stage. Accordingly, we vacate the judgment of dismissal and remand the case for further proceedings.

I.

During the nearly two years from the time Bishop filed his complaint until the district court entered final judgment, this case did not proceed past the pleading and discovery stage. The court, on the defendants' motions to dismiss, considered matters outside the pleadings, treated the motion as one for summary judgment,[3] and entered judgment for the defendants, because the discovery materials considered showed there to be no genuine issue as to the fact of Bishop's lack of reliance on the Offering Circular. In considering the propriety of summary judgment, plaintiff's factual version must be taken as true. *Bishop* v. *Wood*, 426 U.S. 341, 347, 96 S.Ct. 2074, 2079, 48 L.Ed.2d 684, 691 (1976); *E. C. Ernst, Inc.* v. *General Motors Corp.*, 537 F.2d 105, 108 (5th Cir. 1976).

The only fact material to the decision of the district court in dismissing Bishop's complaint was that he did not rely on statements or omissions in the Offering Circular. While that admission correctly controlled the disposition of Bishop's claim that the Circular contained material misrepresentations and omissions (see Part III), we hold its consideration was improper in determining to dismiss his claim based on fraud in bringing the bonds into the marketplace (see Part IV). Therefore, in regard to the latter claim, the dismissal is truly on the pleadings alone. Under *Conley* v. *Gibson*, 355 U.S. 41, 45, 78 S.Ct. 99, 101, 2

[3] Fed.R.Civ.P. 12(b) and 56.

L.Ed.2d 80 (1957), review of the dismissal of this part of the complaint requires us to determine whether Bishop could prove any set of facts in support of his claim which would entitle him to relief.

Reciting the facts most favorably to the plaintiff, as we do below, does not imply that he can prove his allegations.

II.

The bond issue in question had its genesis in 1972 when J. C. Harrelson, president and chief shareholder of Alabama Supply and Equipment Company [ASECo], and Clarence Hamilton, president of Investors Associates of America, Inc., a Tennessee underwriter, decided to seek industrial development financing to construct and equip a facility for the construction of mobile homes in Frisco City, Alabama. Alabama law provides for such financing pusuant to the Wallace-Cater Act, codified in §§ 11-54-80 *et seq.*, Code of Alabama (1975), which authorizes the incorporation of an Industrial Development Board in a municipality in order to induce industry to locate in Alabama. *Id.* § 11-54-81. Such a board has the authority to issue tax-exempt bonds. *Id.* §§ 11-54-87, 11-54-96. With the proceeds of such an issue, a board can build an industrial facility, which it may then lease to a manufacturing, industrial, or commerical enterprise. *Id.* § 11-54-87. The amount of rental payments is calculated to amortize the interest and principal of the bonds and is ostensibly lower than that which could be obtained without tax-free financing.

The Bonds are revenue bonds, not general obligation bonds of the municipality. They must be secured by a pledge of the revenues and receipts from the lease and may be further secured by a mortgage or deed of trust covering the project from which revenues are to be derived. *Id.* §§ 11-54-90. The municipality is in no event liable for the payment of any of a board's obligations, *id.* § 11-54-92; the sole source for the satisfaction of in-

terest obligations and retirement of principal is the lessee's rent payments. *Id.* § 11-54-89.

Neither Harrelson nor ASECo was a paragon of financial integrity or industrial ability. Harrelson had been only moderately successful in previous business ventures and had little experience in the development of plants for the construction of modular or mobile homes. ASECo's management was inept and unsophisticated, its projections for the sales of mobile homes were mere marketing assumptions, and its financial condition was weak. Indeed, Harrelson and Hamilton both knew that ASECo did not have the financial capability to engage in the manufacture of mobile homes and related products or to pay the rent necessary to amortize the principal and interest on the Bonds. Nevertheless, they determined to induce the Town of Frisco City to create an Industrial Development Board to finance ASECo's facility as a scheme to defraud the investing public.

Hamilton retained defendant Jerald H. Sklar, a Tennessee attorney, as bond counsel. Sklar instructed Investors Associates to conduct an investigation of ASECo and retained John Andrews of Capell, Howard, Knabe & Cobbs, a Montgomery, Alabama, law firm, as bond co-counsel. Andrews saw to the incorporation of the Industrial Development Board of Frisco City and issued an opinion on the legality of the authorization and issuance of the Bonds. Sklar drafted the lease, indenture of trust, mortgage, authorizing resolution, guarantee, and closing papers. The Board entered into a lease with ASECo on November 1, 1972. It required ASECo to pay as base rent the amount necessary to amortize the interest and principal of the Bonds. Harrelson unconditionally guaranteed ASECo's payment of rent under the lease. The Board then adopted the resolution adopting the bond issue. The ability of the Board to meet its financial obligations under the issue depended entirely on ASECo's and Harrelson's financial solvency.

Sklar also drafted the Offering Circular, based on material furnished to him by the underwriter, the lessee company, and

those associated with them, but he intentionally or recklessly disregarded other facts of which he was aware. Sklar omitted from the Offering Circular, for example, that the Securities and Exchange Commission had investigated and commenced a civil action against Hamilton and Investors Associates (and against Jackson Municipals, Inc., the assignee who ultimately underwrote the issue) for violations of the securities laws; he even failed to name the underwriter in the Offering Circular. He misleadingly portrayed ASECo as the owner of 519 acres of Florida real estate valued at $2,284,000, already approved for development, recklessly disregarding not only that ASECo had filed no development plans but also that it had no ownership or equity interest in the property. Although Sklar knew that Harrelson had been only moderately successful at past efforts, he falsely represented Harrelson in the Offering Circular as a successful and experienced developer of modular home manufacturing plans with well-established mobile home sales. Furthermore, Sklar relied on an opinion letter that no actions were pending against or threatening ASECo, even though the opinion letter was obviously deficient and was prepared by a lawyer other than the one originally selected to give an opinion, as Sklar knew. In fact, an action affecting the Florida investment real estate listed on ASECo's balance sheet was pending at the time of the opinion letter.

Part of the information Sklar incorporated into the Offering Circular was a financial statement prepared by George C. Rakard, a certified public accountant from Salem, Illinois. Rakard's financial statement was materially false and misleading because of numerous misrepresentations and omissions. It included as assets of ASECo a number of items of doubtful worth. Open notes and capital stock subscriptions from Harrelson and his wife were valued at $376,000, in reckless disregard of their true value and without taking into account the Harrelsons' probable inability to satisfy these obligations. Three-quarters of the [illegible] investment properties, including the Florida real estate in which ASECo in fact had no

interest. Moreover, Although Rakard's forwarding letter accompanying the financial statement stated that the audit faily presented the financial condition of ASECo, Rakard knew or recklessly disregarded the fact that the financial statement constituted mere "window dressing" that did not fairly present ASECo's financial condition.

By the time Sklar incorporated Rakard's financial statement into the Offering Circular, he knew or recklessly disregarded the fact that Harrelson was already in default on at least one of the notes listed as an asset of ASECo and that ASECo was in default on its obligation in the lease to maintain at least $400,000 in working capital.

Meanwhile, Investors Associated had determined that it did not possess sufficient capital to underwrite the proposed issue and assigned the right to underwrite the issue to Jackson Municipals, Inc., a Tennessee underwriting firm headed by Cecil Lamberson. Jackson Municipals and Lamberson proceeded to offer the Bonds for sale to the public on the basis of the Offering Circular, even though they knew it contained materially false misrepresentations and omissions. They knew Harrelson was inexperienced and unsophisticated, contrary to the Offering Circular's representation. They purported to rely on Hamilton and Investors Associates, but because they were all defendants in the same SEC action (which the Offering Circular failed to disclose) they knew that Investors Associates needed to induce another firm to underwrite the bond issue or it would lose the value of all the time and effort it had put into the issue thus far.

Lamberson and Jackson Municipals knew that while Harrelson was not as financially secure as represented, 95% of ASECo's current assets consisted of open notes from Harrelson and over 75% of ASECo's listed assets was the Florida real estate, but failed to investigate the true value of either of these assets. They knew that the financial statement did not reflect ASECo's true assets. They even failed to inquire whether Har-

relson had paid $200,000 due ASECo on a stock subscription, knowing that ASECo would be in default if Harrelson had not. In spite of this knowledge, Jackson Municipals bought the bond issue from the Board in three increments, commencing on December 14, 1972, and resold the Bonds to securities dealers.

The Phenix National Bank (now the First Alabama Bank of Phenix City, NA) had been chosen to act as trustee of the Bond proceeds. The Bank's responsibility was to ensure that the lessee complied with the terms and conditions of the lease, one of which was that ASECo at all times have working capital in the amount of $400,000.00 or more. The Bank had the duty to determine the existence of any default in the lease requirements by the lessee, and to demand a cure of the default or else declare the Bonds due and payable upon failure to cure. The Bank's responsibility commenced with the sale of the first increment of the Bonds, which took place on December 14, 1972. The Bank knew or recklessly disregarded from the date its duties as trustee commenced that ASECo was in breach of the lease requirement that it maintain $400,000.00 in working capital.

The Board entered into an agreement with Coliseum Properties, Inc., to construct part of the facilities contemplated by the bond issue. Coliseum Properties, however, merely served as a vehicle by which substantial parts of the proceeds of the issue were diverted and used for the benefit of others. In particular, the controlling persons of the parent corporation of Coliseum Properties, the so-called "Candler defendants," made improper payments to ASECo and to Harrelson in exchange for the construction contract; moreover, Coliseum Properties and some of its officers were under indictment in several pending suits. None of this information was known to the Board when it entered into the agreement with Coliseum Properties.

In January 1973, Bishop spoke with his broker, Tom Monks, president of Professional Securities, Inc., a Birmingham securities dealer, about Bishop's investment possibilities. Monks advised Bishop that tax-free Bonds, such as those issued

by the Industrial Development Board of the Town of Frisco City, Alabama, were a good investment and he told Bishop of others in the community who had purchased such Bonds.

Bishop purchased three of the Bonds in January, paying $3,052.67, and one more in February, for $1,043.37. The Offering Circular offered the Bonds for sale at 86, that is for $860 per Bond, yet Bishop paid par—$1,000 plus accrued interest for each Bond. The district court found Bishop purchased as part of the primary offering. However, the record does not disclose whether Bishop purchased directly from Jackson Municipals (and, if so, why the price was not as offered), or from his broker acting as principal or from a seller in the secondary market. Industrial development bonds from towns like Frisco City are not ordinarily traded in a secondary market, but Lamberson stated in deposition that these bonds were being traded, that they were marketable securities, and that his firm had bought and sold some. Indeed, it appears that in addition to its underwriting discount, Jackson Municipals had earned $4,500 by trading these securities in the secondary market. The record is likewise silent as to whether Bishop's purchase was the result of one of these trades.

Bishop never saw the Offering Circular nor knew one existed. He bought the Bonds based solely on his broker's oral representations. At about the same time, he purchased a variety of other municipal bonds offered by various industrial development boards, gas districts, and utility authorities, presumably on similar oral advice from his broker.

After the ASECo plant had been constructed, the lessee ceased all operations at the plant and, on April 15, 1974, defaulted in payment of rent under the lease. Although Harrelson had unconditionally guaranteed the performance of the lease by ASECo, he did not have sufficient assets to back up his guarantee. The Trustee Bank declared the lease in default.

III.

Bishop's original complaint sought relief for himself and for the class of all purchasers of the Bonds under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, rule 10b-5, 17 C.F.R. § 240.10b-5, and an unspecified Alabama law. The court dismissed all claims under the 1933 Act, which dismissal Bishop does not appeal, but permitted Bishop to amend his complaint twice in order to allege that he relied on the Offering Circular. Bishop's inability to make such an allegation resulted in the dismissal here on appeal.

To the extent that Bishop pleaded the usual 10b-5 misrepresentation or omission case, the district court was correct. Reliance is an essential element of such a cause of action, though the burden of proving or disproving reliance may shift depending on the nature of the case. The elements of a classic mispresentation action are: (1) the defendant must make a false representation of a material fact, (2) knowing its falsity and intending that the plaintiff rely on it, (3) the plaintiff must justifiably rely on it, and (4) suffer damage as a result. *See* III L. Loss, Securities Regulation 1431 (1961); *Dupuy* v. *Dupuy,* 551 F.2d 1005, 1014 (5th Cir. 1977). Because reliance is so difficult to prove when a defendant has failed to disclose a material fact rather than misrepresenting it, the Supreme Court has allowed the trier of fact to presume reliance in an omission case where the plaintiffs could justifiably expect that the defendants would disclose material information. *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). *Ute* did not eliminate reliance as an element of a 10b-5 omission case; it merely established a presumption that made it possible for theplaintiffs to meet their burden. When the *Ute* presumption attaches, the defendant may rebut it by showing that the plaintiff did not rely on the defendant's duty to disclose. If the plaintiff would have followed the same course of conduct even with full and honest disclosure, then the defendant's action (or

lack thereof) cannot be said to have caused plaintiff's loss. *See Simon* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880 (5th Cir. 1973), *explained in Rifkin* v. *Crow*, 574 F.2d 256 (5th Cir. 1978).

Bishop alleged that the Offering Circular contained material misrepresentations and failed to state material facts necessary to make the statements made not misleading. At the same time, he admitted that he never read or otherwise relied on the Offering Circular. If the *Ute* presumption applies to these non-disclosures, Bishop's admission rebuts it. Bishop's claim that he was deceived by the misrepresentations and omissions of the Offering Circular was correctly dismissed by the district court because of his failure to read or even seek to read the Offering Circular.

IV.

The district court erred, however, in construing the remainder of Bishop's complaint as narrowly confined to charges of misrepresentations and omissions in the Offering Circular that would have defrauded investors who did rely. It would permit proof that the defendants engaged in an elaborate scheme to create a bond issue that would appear genuine but was so lacking in basic requirements that the Bonds would never have been approved by the Board nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud. Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme.

Rule 10b-5 provides in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, . . .

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Bishop's complaint specifically tracks the language of all three subsections of the rule.[4] As we have stated in Part III, Bishop's

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[4] In Count I he states;

In connection with the sale of the Bonds, J. C. Harrelson (now deceased) and others, by the use and means of instrumentalities of interstate commerce and the mails, did or caused the following to be done:

(a) Employed one or more devices, schemes and artifices to defraud Plaintiff and members of the class;

(b) Made to Plaintiff and other members of the class, untrue statements of material fact and omitted to state material facts necessary to be made in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of the Bonds;

(c) Engaged in acts, practices and courses of business and conduct which operated as a fraud and deceit upon plaintiff and members of the class in connection with the purchase and sale of the Bonds.

In Count II his allegations practically reiterate 10b-5(1) and (3):

In connection with the offer and sale of the bonds, the defendants hereinafter named entered into and participated with J. C. Harrelson in a conspiracy, scheme or agreement to employ devices, schemes and artifices to defraud, and to engage in acts, practices and courses of business which would and did operate as a fraud and deceit upon the Plaintiff and other members of the class sued for herein.

10b-5(2) claim contained in Count I cannot withstand his admitted lack of reliance on the Offering Circular. However, his 10b-5(1) and (3) claims in Counts I and II assert something more that prevents dismissal at this preliminary stage.

Bishop could prove that he made a general request to his broker to purchase industrial development bonds, that his actual purchases covered a number of different issues, and that he did not undertake to determine which among the issues then offered were the most prudent investments or to second-guess the underwriters in the price and coupon rate they set. His pleadings would permit him to show that he was willing to accept any marketable risk. If a municipal authority was willing to authorize the issuance of the Bond, and the underwriters were willing to present the issue to the market, that was sufficient for Bishop's purposes. His pleadings allow him to show that he sought to make investments in securities which were entitled to be marketed.

It is unnecessary here to decide whether a distinction should be drawn between the terms "loss causation" and "transaction causation." *See Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 384 (2d Cir. 1974) (Frankel, J., concurring). The concept of this scheme to defraud satisfies the requirement of "transaction causation." *Id.* at 381; 1 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 4.7 (558)-(559), at 86.25, 86.32 (1979).[5] It has as its core objective that the poten-

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[5] Misrepresentation actions brought under 10b-5(2) may require a separate showing of "transaction causation." In such a case, "the test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.' " *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965) (quoting Restatement, Torts § 546 (1938)). Doing away with the conventional reliance requirement in a 10b-5(2) case, therefore, could establish a scheme of investors' insurance.

tial victim engage in the transaction for which the scheme was conceived. The requisite element of causation in fact would be established if Bishop proved the scheme was intended to and did bring the Bonds onto the market fraudulently and proved he relied on the integrity of the offerings of the securities market. His lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative. *Blackie* v. *Barrack*, 524 F.2d 891, 906 (9th Cir. 1975).

Bishop has alleged the necessary elements of an action under 10b-5(1) or (3). In the literal words of rule 10b-5, he must be able to show a "scheme ... to defraud ... or ... [an] act, practice or course of business which operates ... as a fraud or deceit upon [him] ... in connection with the sale of [the Bonds] ...." Bishop's burden of proof will be to show that (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) Bishop reasonably relied on the Bonds' availability on the market as an indication of their apparent genuineness,[6] and (3) as a result of the scheme to defraud, he suffered a loss.

V.

The thrust of the arguments against our holding is that a recovery in this circumstance is not consonant with the central purpose of the securities laws, which, it is argued, is to provide

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[6] After *Hochfelder*, *infra*, this circuit's requirement that the reliance be reasonable or justifiable means only that the plaintiff must not "intentionally refuse[] to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.' " *Dupuy* v. *Dupuy*, 551 F.2d 1005, 1020 (5th Cir. 1977) (quoting W. Prosser, Law of Torts § 34, at 185 (1971)). Defendants do not suggest that a decision to invest in the municipal obligations of Frisco City, Alabama, without more, constitutes an intentional disregard of an obvious risk.

full disclosure so that investors may make informed investment decisions. It is asserted that allowing recovery to one who has never read the Offering Circular minimizes the importance of such documents and discourages investors from reading them.[7]

We disagree. First, the purposes of the securities acts and rule 10b-5 are far broader than merely providing full disclosure or fostering informed investment decisions. The Supreme Court has held that the acts were designed "to protect investors against fraud and ... to promote ethical standards of honesty and fair dealing. See H.R. Rep.No. 85, 73d Cong., 1st Sess., 1-5 (1933)." *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668, 677 (1976). This court has held that "[t]he basic intent of section 10(b) and rule 10b-5 and indeed, of the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings." *Sargent* v. *Genesco, Inc.,* 492 F.2d 750, 760 (5th Cir. 1974). *See also Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84, 91, 93 n.20 (5th Cir. 1975); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228, 235, 240 (2d Cir. 1974) ("to secure fair dealing"). Thus, the central purpose of the acts is the protection of investors, *Tcherepnin* v. *Knight,* 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564, 569 (1967); *Woodward* v. *Metro Bank,* 522 F.2d 84, 91 (5th Cir. 1975); *Bellah* v. *First*

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[7] This argument ignores § 11 of the Securities Act of 1933, which allows recovery for untrue statements or omissions of a material fact in the registration statement without proof of reliance. Even when the exception in § 11(a) applies, a plaintiff need not prove that he read the registration statement. Although municipal bonds are exempt from the registration requirements of the 1933 Act, the exemption does not indicate a congressional intent that aggrieved purchasers of municipal bonds must have read an Offering Circular in order to recover. Certainly there are differences between §§ 11 and 12 of the 1933 Act and § 10(b) of the 1934 Act and rule 10b-5. We point to the former provisions only to indicate that Congress did not have a pervasive intent to require plaintiffs under the securities laws to read or rely specifically on a prospectus or circular.

*National Bank*, 495 F.2d 1109, 1111 (5th Cir. 1975); *Herpich* v. *Wallace*, 430 F.2d 792, 801, 806-08 (5th Cir. 1970), and the promotion of free and honest securities markets. *Id.* The acts reach complex fraudulent schemes as well as lesser misrepresentations or omissions. Full disclosure is only one means, albeit a central one, of achieving these paramount goals.[9]

Second, the role of the Offering Circular will continue undiminished even if Bishop proves his allegations and recovers. He has alleged that the fraud caused the Bonds to be offered for sale on the market. If Bishop proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover. Thus, a purchaser of securities will still have the strongest incentive to read the disclosure statement if he wants to ensure he gets full value for his securities purchases.

Under Bishop's broader theory, it would have availed him nothing to have read the Offering Circular. This theory is not that he bought inferior bonds, but that the Bonds he bought were fraudulently marketed. The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place.

Finally, we reject the contention that our holding imposes new burdens on defendants or enhances their liability. Lawyers, underwriters, and accountants who participate in bond issues in good faith are unaffected by our decision. Liability results only if they act with intent to deceive or defraud. None of these parties may be held liable for mere negligent performance of whatever role they choose to play, for the plaintiff must prove

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[9] The schemes must, of course, be one within the "manipulative" condemnation of the securities law. *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). This one clearly is.

that the defendants acted with the requisite scienter. *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); *Aaron* v. *SEC*, 446 U.S. 680, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980).[9]

VI.

The dissent asserts that we adopt a "new theory" because we separate Bishop's claim under 10b-5(2) that the Offering Circular was misleading from his claim under 10b-5(1) and (3) that defendants' fraudulently marketed Bonds caused his loss. It is not our "theory" but the words of rule 10b-5 which confer the right of action we hold Bishop is entitled to try to prove. Contrary to the assertion of the dissent, neither this court nor the Supreme Court has held these parts of the rule do not mean what they say. Misrepresenation and omission cases under 10b-5(2) which, as we do, require reliance on the document making the misrepresentation or omitting a material fact are inapposite to a case in which the buyer relied on the integrity of the market to furnish securities which were not the product of a fraudulent scheme. This circuit has said so,[10] and other circuits have also.[11] There is no Supreme Court precedent to the contrary.

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[9] The Court has yet to decide "whether, under some circumstance, scienter may also include reckless behavior." *Aaron*, 446 U.S. at 686 n.5, 100 S.Ct. at 1950 n.5. This court has decided that it may. See *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 535, 545 (5th Cir. 1981); *Thompson & Co., Inc.* v. *Partridge*, 636 F.2d 945, 959 (5th Cir. 1981).

[10] *Rifkin* v. *Crow*, 574 F.2d 256 (5th Cir. 1978).

[11] *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975); *Schlick* v. *Penn Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974).

We do not overrule *Rifkin* v. *Crow*. Rather, we cite it approvingly for the rule 10b-5(2) principle it decides and hold it requires affirmance of the dismissal of that part of Bishop's claim. Moreover, *Rifkin*, is helpful to our holding here in two other respects. It points out that this circuit had not previously decided whether a buyer could rely on a "fraud on the market" theory as developed in the Second and Ninth Circuits.[12] *Rifkin* also explains that our prior decision in *Simon* v. *Merrill Lynch, Pierce, Fenner & Smith*, (holding the lack of "general reliance" on a stockbroker's misrepresentations foreclosed any right of action) would not apply to such a broader theory of fraud if it were developed on remand. "In other words, *Simon's* 'general reliance' language simply requires there to be a causal link between defendant's violation and plaintiff's harm in order for plaintiff to recover." 574 F.2d 262 n.1.

The dissent asserts that *Affiliated Ute Citizens* v. *United States*, and *List* v. *Fashion Park, Inc.*, taken together suggest that Bishop's admitted nonreliance on statements or omissions in the Offering Circular precludes any recovery for harm caused by the broader scheme to bring the Bonds onto the market by fraud. We disagree. *Ute* and *List* emphasized that the role of reliance in securities actions is to establish causation. In *Ute*, silence in the face of a duty by bank employees to disclose self-dealing established "the requisite element of causation in fact." 406 U.S. at 154, 92 S.Ct. at 1472. Furthermore, *Ute* expressly recognized that rule 10b-5 was not limited to dealing with misrepresentation or omission cases under 10b-5(2), but reached "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud...." 406 U.S. at 153, 92 S.Ct. at 1472. *List* stated that the reason for the reliance requirement "is to certify that the conduct of the defendant actually caused the plaintiff's injury." 340 F.2d at 462. Whenever the rule 10b-5 issue shifts

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[12] *See* cases cited in footnote 11, *supra*.

from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The "reliance" that produces causation in the latter type of case cannot come from reading a document. It may arise from the duty to speak as in *Ute,* a scheme to manipulate the market at a time when a merger had forced a sale as in *Schlick,* a scheme to inflate common stock prices by misleading statements as in *Rifkin,* or a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created as we have here. The most significant common thread in all these precedents is that rule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer. The rule is recognized also to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities.

The dissent suggests that our holding needlessly imports a state law cause of action for conversion into the federal securities law. Again we disagree. It is the recognized right of action created by rule 10b-5 which we hold Bishop was denied. This cause of action has its roots in congressional enactment, federal regulation and federal precedent. We merely decline to diminish it.

VII.

The judgment dismissing plaintiff's complaint is vacated and the cause remanded for further proceedings not inconsistent with this opinion. The district court also ruled that this action could not be maintained as a class action because of lack of typicality, lack of adequate representation, and lack of a showing that common questions of fact would predominate. All three of these determinations, however, were premised on the belief that reliance on the Offering Circular was crucial to Bishop's claim. On remand, the court must reconsider the main-

tainability of this action as a class action as to members of a properly defined class of Bond purchasers who did not so rely.[13]

VACATED and REMANDED.

* * * * *

RANDALL, Circuit Judge, with whom BROWN, RONEY, GEE, TJOFLAT, JAMES C. HILL, FAY, ALVIN B. RUBIN, REAVLEY and HATCHETT, Circuit Judges, join, dissenting.

The majority opinion today adopts a new theory of recovery in federal court under Rule 10b-5. It holds that a purchaser of securiites offered to the public by means of a misleading offering circular, who has heretofore been foreclosed from recovering in federal court under Rule 10b-5 because of his admitted lack of reliance on the offering circular, will not henceforth be foreclosed from recovering under the Rule if he is able to prove that the defendants knowingly conspired to bring securities onto the market which were not "entitled to be marketed" and that he reasonably relied on the availability of the securities on the market as an indication of their entitlement to be marketed.

This newly-devised route to recovery under Rule 10b-5 is completely without supporting precedent; indeed, it conflicts with the prior decisions of this and every other circuit and with the clear implication of recent Supreme Court decisions in the securities field. But even if the majority were writing on a blank slate, its novel holding would be profoundly unwise for several reasons. First, it introduces into the law under Rule 10b-5 a distinction between securities that are "entitled to be marketed," *i. e.*, securities that may be the subject of a

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[13] The court previously determined the maintainability of a rule 10b-5(2) class action for Bond buyers who could establish reliance on the Offering Circular. The requirement to reconsider the maintainability of an additional class action does not affect that determination.

fraudulent marketing scheme, but which, absent the fraud, could be sold at *some* price, and securities that are not "entitled to be marketed." *i. e.,* securities that are the subject of a fraudulent marketing scheme and that, absent the fraud, could not be sold at *any* price. The requirements for recovery under Rule 10b-5 in any case hinge upon which category of securities the defrauded plaintiff purchased. If he purchased a security that was entitled to be marketed, he must have relied on the defendants' misrepresentations or omissions in order to recover. If, however, he can show that he purchased a security which was not entitled to be marketed, he can recover in spite of his nonreliance on the defendants' misrepresentations or omissions if he can show that he reasonably relied on the integrity of the marketplace to offer him securities that were entitled to be marketed. This novel theory permits recovery under the Rule to one who has elected not even to seek to read what the seller is obligated by the Rule to disclose, thereby defeating the primary objective of the Rule-the making of an informed investment decision. Second, the majority opinion has great potential for increasing the volume of litigation under Rule 10b-5 by providing a federal forum to those plaintiffs who by their own actions would otherwise have forfeited the protection of the Rule and have relegated themselves to state court actions for conversion. Finally, the majority opinion also has great potential for protracting much Rule 10b-5 litigation that would heretofore have terminated at the summary judgment stage. For these reasons, I respectfully dissent.

## I. THE MAJORITY'S TREATMENT OF THE RELIANCE REQUIREMENT

The majority begins part III of its opinion by acknowledging that reliance is an essential element of a misrepresentation or omission case under section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b) (1976). The opinion notes that the trier of fact may presume reliance in an

omissions case (as distinguished from a misrepresentations case) in which the plaintiff could justifiably have expected that the defendant would disclose material information. However, that presumption is said by the majority to be rebuttable and is held to have been rebutted in this case by Bishop's admitted failure to read or even seek to read the offering circular.

The majority opinion goes on to distinguish between Bishop's Rule 10b-5(2) case based on misrepresentations and omissions in the offering circular, as to which summary judgment was proper because of Bishop's admitted lack of reliance on the offering circular, and Bishop's Rule 10b-5(1) and (3) case based upon a scheme to defraud and an act that operates as a fraud, each having as its objective the issue and sale of bonds which were not entitled to be marketed. As to the latter case, lack of reliance by the plaintiff on the offering circular, which is described as "only one component of the overall scheme," is held to be not fatal. Instead, proof of reliance by the plaintiff on the availability of the bonds on the market as an indication that they were entitled to be marketed will suffice.

By way of explanation, the majority opinion tells us that the role of reliance in securities actions is to establish causation, and that whenever the issue under Rule 10b-5 shifts from misrepresentations or omissions in a document to "fraud on a broader scale," the search for causation must also shift. In fraud on a broader scale, the reliance that establishes causation "cannot come from reading a document," but instead can consist of reliance on the market to provide securities that are entitled to be marketed. Thus we are told that we need to view Bishop's case as not simply one of the class of cases in which the fraud is accomplished by means of misrepresentations and omissions in an offering circular (in which the absence of reliance by the plaintiff on the offering circular would be fatal to the plaintiff's case) but instead as one in a class of cases involving "fraud on a broader scale" or "more elaborate, intentional schemes which deceive or defraud purchasers of securities" (in which the

reliance that is needed is simply reliance on the integrity of the market to provide securities that are entitled to be marketed). We are told this in spite of the fact that Bishop's complaint is *accurately* summarized in the opening lines of the majority opinion as alleging "in essence ... that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development Board ['Board'] to issue, and the public to buy, fraudulently marketed bonds."

The only direct authority cited by the majority for its novel holding is the Rule itself,[1] which makes it unlawful in connection with the sale of a security to employ any scheme to defraud (clause 1) or to engage in any act which operates as a fraud (clause 3). With deference, I suggest that if it were possible to circumvent the requirement of clause (2) of the Rule of reliance on the defendants' misrepresentations or omissions simply by falling back on the sweeping language of clauses (1) and (3) of the Rule in combination with allegations of elaborate fraud, there would be numerous cases to cite as direct authority for the majority's holding. In fact, there are none.

## II. PRIOR PRECEDENT RELATING TO THE RELIANCE REQUIREMENT

### *A. The Origins and Function of the Reliance Requirement*

Perhaps the seminal modern case on the reliance requirment is *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2nd Cir.), *cert. denied*, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965). The

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[1] In arguing that its holding does not conflict with prior precedent of this circuit or the Supreme Court, the majority virtually concedes that there is no direct *precedential* support for its interpretation of clauses (1) and (3) of the Rule: "It is not our 'theory' but the words of rule 10b-5 which confer the right of action we hold Bishop is entitledto try to prove. Contrary to the assertion of the dissent, neither this court nor the Supreme Court has held [that] these parts of the rule do not mean what they say." *Ante*, 647 F.2d at 471.

gravamen of List's complaint was that the defendants had utterly failed to disclose certain material facts, and that as a result thereof, he had lost money in selling securities.[2] The defendants argued that the language of clauses (1) and (2) of Rule 10b—5 could not support liability in a total nondisclosure case, but the Second Circuit firmly rejected the defendants' suggested distinctions that were based on the differing language of the three clauses; instead, the court relied upon the Rule as a whole for its holding that total nondisclosures fell within the ambit of Rule 10b—5 and section 10(b). *Id.* at 462. Drawing upon the elements of the common law tort of misrepresentation, the Second Circuit incorporated into the private cause of action under Rule 10b—5 the requirement that the plaintiff have relied upon the defendants' misrepresentations or omissions, even in a total nondisclosure case:

> [T]he test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.' . . . The reason for this requirement . . . is to certify that the conduct of the defendant actually caused the plaintiff's injury . . . .
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> . . . .

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[2] In *List*, the plaintiff was an experienced and successful investor who had purchased 5,100 shares of Fashion Park stock in 1959 at $13.50 per share. In November 1960, with the advice of his broker, List authorized the sale of his stock at a net price to him of not less that $18 per share. List's broker knew that at that time, two directors of Fashion Park were bidding for Fashion Park stock through the pink sheets, but the broker did not think it important to disclose this fact to List, and List made no effort to learn whether the directors were in the market for the stock. Another development was the adoption of a resolution by the board of directors of Fashion Park on November 4, 1960, to merge into another company. Fashion Park did not issue a press release about the merger. List sold his stock in mid-November 1960, at $18.50 per share, without knowing that one of Fashion Park's directors was the purchaser or that Fashion Park's management was considering the sale of the company.

> This interpretation of Rule 10b—5 is a reasonable one, for the aim of the rule in cases such as this is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investors' insurance. Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the interpretation for which plaintiff contends might advance the purposes of Rule 10b—5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact.

*Id.* at 462-63 (bracketed portion inserted by Second Circuit). In applying this principle to the case before it, the Second Circuit held that the trial court's detailed findings of fact, to the effect that List would have sold his stock even had he been aware of the undisclosed information, were not clearly erroneous; accordingly, the showing of causation necessary to support a private recovery under Rule 10b—5 was missing, and List could not recover.

This court promptly adopted the rule of *List*. *E. g.*, *Herpich* v. *Wallace*, 430 F.2d 792, 805 & n.12 (5th Cir. 1970) (citing *List*); *Grumbles* v. *Times Herald Printing Co.*, 387 F.2d 593 (5th Cir.), *cert. denied*, 390 U.S. 1028, 88 S.Ct. 1419, 20 L.Ed.2d 285 (1968) (affirming per curiam a judgment for defendant on basis of adequately supported jury findings that plaintiff did not rely and that omitted facts were not material).

*B. Modifications to the Manner in Which the Reliance Requirement May Be Satisified*

Subsequent to the *List* decision, the federal courts have developed two modifications in the manner in which reliance may be established, both of which are aimed at overcoming what would otherwise be virtually insurmountable obstacles for plaintiffs. The first modification applies only to nondisclosure

cases—*i.e.*, those cases in which the defendants have remained silent in the face of a duty to disclose. The second modifications applies only to certain "fraud on the market" claims—typically class actions in which a great many plaintiffs have allegedly suffered losses in the secondary trading market as a result of misrepresentations or omissions in a series of documents promulgated by the defendants over a period of time.

*1. The rebuttable presumption of reliance in total nondisclosure cases.*—In many instances, the violation of Rule 10b—5 complained of by the plaintiff is a total failure to disclose material information, as was true in *List*. Early in the 1970s' the federal courts increasingly became aware that in such total nondisclosure cases, a plaintiff faces almost an insurmountable burden if he is required to present affirmative evidence that he relied specifically on the defendants' silence with regard to a material fact.

The Supreme Court first addressed this problem in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). The defendants in *Affiliated Ute*, who were marketmakers in the stock of a company holding assets for certain Indians, as well as sales agents for the Indians, had remained silent as to prevailing market prices for the stock in circumstances in which they had a duty to disclose those prices. The Indians "considered these defendants to be familiar with the market for the shares of stock and *relied upon them* when they desired to sell their shares." *Id.* at 152, 92 S.Ct. at 1471 (emphasis added).[3] The Supreme Court held that the Tenth Circuit had

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[3] *See also Chiarella* v. *United States*, 445 U.S. 222, 229—30, 100 S.Ct. 1108, 1115, 63 L.Ed.2d 348 (1980) (including, in a description of *Affiliated Ute*, a reference to the reliance by the Indian sellers upon the Bank's personnel).

> erred when it held that there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by [the defendants]. We do not read Rule 10b—5 so restrictively. *To be sure, the second sub-paragraph of the rule specifies the making of a untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted.* These defendants' activities, outlined above, disclose within the very language of one or the other of those subparagraphs, a "course of business" or a "device, scheme, or artifice" that operated as a fraud upon the Indian sellers. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, [404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128] (1971)]. . . . The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market . . . .
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> *Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.* All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

*Id.* at 152-54, 92 S.Ct. at 1471-1472 (emphasis added; some citation omitted).

The courts of appeals have not read *Affiliated Ute* as having done away with the reliance requirement altogether. Rather, *Affiliated Ute* has been read to establish a rebuttable presumption what the plaintiff relied upon the defendant's silence in total nondisclosure cases, at least so long as the facts as to which the defendants were silent meet the materiality requirement. For example, in *Rifkin* v. *Crow*, 574 F.2d 256 (5th Cir. 1978), the law

in this circuit on reliance was carefully summarized and restated, with special attention paid to *Affiliated Ute:*

> After *Ute,* the reliance requirement has varied somewhat in articulation from circuit to circuit, but a general pattern seems to have emerged: where a 10b—5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information. Upon a failure of proof on the issue, defendant loses. But this presumption of reliance in nondisclosure cases is not conclusive. *If defendant can prove that plaintiff did not rely, that is, that plaintiff's decision would not have been affected even if defendant had disclosed the omitted facts, then plaintiff's recovery is barred.*

*Id.* at 262-63 (footnotes omitted). *Accord, Huddleston* v. *Herman & MacLean,* 640 F.2d 534, 547-50 (5th Cir. 1981) ("reliance is an issue in *all* Rule 10b—5 cases"); *Dwoskin* v. *Rollins, Inc.,* 634 F.2d 285, 291 n.4 (5th Cir. 1981); *Moody* v. *Bache & Co.,* 570 F.2d 523, 528 (5th Cir. 1978); *Vohs* v. *Dickson,* 495 F.2d 607, 622 (5th Cir. 1974); *Rochez Brothers, Inc.* v. *Rhoades,* 491 F.2d 402, 410 (3d Cir. 1974); *Simon* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 482 F.2d 880, 884-85 (5th Cir. 1973). Indeed, until today, this circuit has uniformly required not only that there have been reliance (whether established by means of an unrebutted presumption under *Affiliated Ute* or proved directly by the plaintiff), but also that the plaintiff's reliance have been *reasonable.*[4]

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[4] Judge John Minor Wisdom, writing for our court in *Dupuy* v. *Dupuy,* 551 F.2d 1005 (5th Cir.) *cert. denied,* 434 U.S. 911, 98 S.Ct.

The majority opinion does not purport to overrule any of these cases. Indeed, it specifically disclaims any intent to overrule *Rifkin* by treating it as a case arising only under clause (2) of Rule 10b—5. Admittedly, the opinion in *Rifkin* does not make an explicit distinction between cases arising under clause (2) of the Rule and those arising under clauses (1) and (3). But *Rifkin* does make a clear distinction between misrepresentation and omission cases, and its holding as to the latter is premised on Affiliated Ute (which was itself a holding under clauses (1) and (3)). This leads me to believe that in *Rifkin* and its progeny this court has spoken to the question of whether proof of nonreliance bars recovery in a case arising under clauses (1) and (3)—and has held that it does. *Huddleston* v. *Herman & MacLean, supra,* reads *Rifkin* in this manner.

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312, 54 L.Ed.2d 197 (1977), summarized the elements of a private cause of action under Rule 10b—5:

> The courts have established that with regard to private recovery for the violation of rule 10b—5, a properly stated cause of action must establish the scienter of the defendant, the materiality of any misrepresentation or omission by the defendant, *the extent of actual reliance by the plaintiff on the defendant's statements, and the justifiability of the reliance,* frequently translated into a requirement of due diligence by the plaintiff.

*Id.* at 1014 (emphasis added; footnotes omitted). The argument made in *Dupuy* was that because *Ernst & Ernst* v. *Hockfelder,* 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), required that the plaintiff prove scienter as part of his cause of action, the plaintiff's lack of diligence in investigating the information available to him should not defeat recovery because the defendant's culpability would be of a far greater degree. The *Dupuy* court rejected this argument, however:

> [T]o abandon completely the consideration of reliance in fact and reasonable reliance ignores not only the above[-stated] policies of due diligence but also the need for a causal link between the misrepresentation or omission and the injury suffered by the private plaintiff. The cause of action would no longer provide compensation for losses occasioned by the violation of the [1934] Act because a plaintiff could sue without relying on the fraud. This would transform the action into an enforcement mechanism. We reject this approach . . . .

Further, the majority opinion squarely conflicts with the decision of the Eighth Circuit in *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978). Although the majority chooses not to discuss *Vervaecke*, that case also involved an initial public offering of bonds and featured a plaintiff who, by his own admis-

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*Id.* at 1016. The court did agree, however, that *Hockfelder* called for a modification of the standard of care under which the plaintiff's conduct would be judged—*i.e.*, a modification that would broaden the definition of "reasonable" reliance. Backing away somewhat from our previous definition of reasonableness, as expressed in cases such as *Clement A. Evans & Co.* v. *McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970). *cert. denied*, 402 U.S. 988, 91 S.Ct. 1660, 29 L.Ed.2d 153 (1971), the *Dupuy* court held that mere negligence was not enough to make the reliance unreasonable; instead, to defeat recovery on grounds that the plaintiff's reliance was unreasonable, the plaintiff's conduct must have been a refusal to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. 551 F.2d at 1020.

This court has steadfastly adhered to *Dupuy's* requirement that the plaintiff's reliance have been reasonable—*i.e.*, within the standard of care articulated by the *Dupuy* court. *See, e. g., Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111, 1121-22 (5th Cir. 1980) (Charles Clark, J.); *Swenson* v. *Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980).

The majority points out that there has been no allegation in this case that Bishop lacked due diligence. *Ante*, 647 F.2d at 470 n.6. But since there was positive proof of Bishop's *nonreliance*, there is simply no issue as to the reasonableness of Bishop's reliance.

Nonetheless, *Dupuy* and its progeny are extremely relevant to our inquiry: Judge Wisdom's reasoning, in rejecting the argument that the reasonableness of the plaintiff's reliance should not be a part of his cause of action, is equally applicable in this case, where the majority dispenses not with the requirement that the plaintiff's reliance be reasonable, but with the more fundamental requirement that he have relied in the first place.

sion, had not relied on a defective offering circular. Sensing that his admission might be fatal to a clause (2) claim, he urged that his case should be considered as one involving primarily nondisclosure cognizable under clauses (1) and (3) of Rule 10b—5. The Eighth Circuit specifically declined to do so and held instead that the district court had properly granted summary judgment for the defendants because of the plaintiff's admitted nonreliance on the offering circular.

Regardless of whether the majority opinion conflicts direclty or only indirectly with the cases discussed above. it is clear at least that *none* of these prior cases dealing with the reliance requirement even indirectly supports the majority's holding today. If those cases are not explicitly overruled, I believe that for the reasons expressed below in part III, their practical vitality has been emasculated *sub silentio* by the majority.

2. *Reliance in "fraud on the market" class actions.*—In insisting that it is not overruling *Rifkin* v. *Crow,* the majority notes in part VI of its opinion that *Rifkin* "points out that this circuit *had not previously* decided whether a buyer could rely on a 'fraud on the market' theory as developed in the Second and Ninth Circuits"[3] In an accompanying footnote, the majority cites *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374 (2d Cir. 1974), *cert. denied,* 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed.2d 467 (1975), and *Blackie* v. *Barrack,* 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976). *Schlick* is not a "fraud on the market" case in the usual sense of that term, but as discussed below in part II—*C,* it represents another sort of modification to the reliance requirement. *Blackie,* however, is the seminal and best known of the "fraud on the market" cases. Earlier, in part IV of its opinion, the majority cites *Blackie* for the proposition that Bishop's "lack of

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[3] *Ante,* 647 F.2d at 471 & n.12. *Rifkin* lists a number of "fraud on the market" cases in addition to *Blackie. See* 574 F.2d at 263 n.4.

reliance on the Offering Circular, only one component of the overall scheme, is not determinative."[6] The inference is that the majority believes that *Blackie* and the other "fraud on the market" cases support its holding in the case at bar.

*Blackie* is typical of the "fraud on the market" cases in that it involved an extremely large class of plaintiffs who purchased the securities of an issuer at different times over an extended period. The gravamen of the claims of all members of the putative class was the alleged misrepresentation by the issuer of its true financial condition in annual and interim reports, press releases, and SEC filings. One ground upon which the defendants resisted the named plaintiffs' motion for class certification was that the need for direct proof of subjective reliance by each class member would inevitably create sufficient conflicts between class members and the named plaintiffs as to make the named plaintiffs' representation inadequate.

The Ninth Circuit recognized that it was virtually impossible in the context of classwide proceedings for each class member to present direct proof of his subjective reliance.[7] The court therefore established a rebuttable presumption for those cases alleging deception that inflated the price of stock traded on the open market:

> [P]roof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b—5 claim for a deception inflating the price of stock traded in the open

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[6] *Ante*, 647 F.2d at 469.

[7] *Cf. Hudleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) ("in a class action, while the materiality element can be established for the class as a whole, reliance, like damages, is a matter of individual proof").

> market. Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumtantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

*Id.* at 906 (citations omitted). Drawing upon a distinction made by the Second Circuit in *Schlick* between "loss causation" and "transaction causation," the Ninth Circuit specifically rejected the notion that a Rule 10b—5 action can be predicated solely on a showing of loss causation:

> The 10b—5 action remains compensatory; it is not predicated solely on a showing of economic damage (loss causation). We merely recognize that individual "transactional causation" can in these circumstances be inferred from the materiality of the misrepresentation, *see Tucker* v. *Arthur Andersen & Co.*, [67 F.R.D. 468, 480 (S.D.N.Y.1975)]; *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 381—382 (2d Cir. 1974), and shift to defendant the burden of disproving a prima facie case of causation. Defendants may do so in at least 2 ways: 1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and 2) *by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it.*

*Id.* (footnote omitted; emphasis added).

*Blackie's* significance to the case at bar rests in its holding that despite a presumption of reliance in "fraud on the market"

cases, the defendant may still defeat recovery by positive proof of nonreliance. The Ninth Circuit has consistently adhered to this rule. *E. g., Keirnan* v. *Homeland, Inc.*, 611 F.2d 785, 788-89 (9th Cir. 1980). Thus, *Blackie* provides absolutely no support for the majority's partial abandonment of the reliance requirement.

*C. The Limited Circumstances in Which Reliance May Be Unnecessary*

My own research reveals only one factual situation in which the reliance requirement arguably would be unjustified. That situation was presented in *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 97 S.Ct. 57, 50 L.Ed.2d 75 (1975)—a case cited by the majority in connection with a distinction between "loss causation" and "transaction causation."[8]

Schlick did not allege fraud resulting in his purchase of a security; instead, he alleged that a fraudulent proxy statement was one step in a scheme that led to the forced liquidation of his security.[9] The Second Circuit noted that this was *not* a typical Rule 10b—5 case:

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[8] *Ante*, 647 F.2d at 469.

[9] Plaintiff Schlick was a minority shareholder in Continental Steel; defendant Penn-Dixie had become a majority shareholder in Continental and thus had voting control. Schlick alleged that Penn-Dixie, by causing Continental's assets to be used for its own purposes, artificially depressed the market price of Continental stock and inflated the market price of Penn-Dixie stock. Schlick alleged that, as part of a scheme, Penn-Dixie proposed to merge Continental into a Penn-Dixie subsidiary but failed to disclose in a proxy statement issued before the merger the manner in which Penn-Dixie had inflated the value of its shares at the expense of Continental. Penn-Dixie then merged Continental into a subsidiary, with the result that the minority shareholders in Continental received an unfairly low exchange ratio.

> This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both *losscausation*—the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question. The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more.

507 F.2d at 380 (emphasis in original; footnote omitted). The court went on to explain the two ways in which a plaintiff could make a prima facie showing of transaction causation:

> In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm. . . . In an omission or

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Significantly, Continental's minority shareholders had no power to prevent the merger. Under state law a majority of the outstanding shares was all that was required in order to effect the merger. The exchange of the Continental shares held by Schlick and the other minority shareholders for those of the Penn-Dixie subsidiary was, effectively, a forced sale in which they made no investment decision. Schlick's class action, which was founded upon sections 10(b) and 14(a) of the 1934 Act, and Rules 10b-5 and 14a-9 thereunder, was dismissed by the district court on the ground that it failed to present any allegation of injury which was *caused* by the allegedly false and misleading proxy statement other than that caused by the unfair merger itself. After reviewing the allegations of the complaint and the decision of the district court, the Second Circuit noted that the nature of the fraud alleged in the complaint—engagement in a course of business which operated as a fraud and deceit on the purchasers and holders of Continental stock—was encompassed by clause (3) of Rule 10b-5.

> nondisclosure case based upon Rule 10b-5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material "in the sense that a reasonable investigator might have considered them important" in making his investment decisions.

*Id.* As an exception to the general proposition that a plaintiff must allege and prove transaction causation to recover under Rule 10b-5, the court carved out a limited exception:

> Under the 10b-5 count, *proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms,* of which the proxy omissions and misrepresentations are only one aspect. Thus appellant need only show loss causation with respect to his claim for relief under 10b-5; [the court below] found and we agree that this has been shown. Here the complaint clearly alleges that, *as a result of the merger, appellant was forced to sell* his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated market value of Continental stock, and that he sustained injury accordingly.

*Id.* at 381 (emphasis added).

*Schlick,* then did not even arguably fit within clause (2) of Rule 10b-5. The misrepresentations and omissions in the proxy statement did not cause the plaintiff's loss. Instead, the claim involved, to paraphrase the Second Circuit's opinion, a forced sale in which the plaintiff had no opportunity to make an *investment decision* and in which, therefore, the defendants' misrepresentations and omissions in, the proxy statement were not the sole mechanism—or even the *key* mechanism—through which the fraudulent scheme was to be accomplished. The ob-

ject of the scheme was not to induce the minority stockholders to make an erroneous decision based on the misstatements and omissions in the proxy statement, for their decision on the proxy solicitation was irrelevant to the success of the scheme; rather, those misstatements and omissions were part of the alleged plan to cover up the essence of the fraud, which was the manipulation of stock prices to set the scene for an unfair exchange ratio in a forced merger. Transaction causation was irrelevant because the minority shareholders were not called upon to make an investment decision. The specific holding of the *Schlick* case, then, can be summarized as follows: when a plaintiff alleges that he has sustained a loss as the result of a fraudulent scheme to bring about a forced sale of his security, he need not plead or prove transaction causation (including reliance, actual or presumed) because he has made no investment decision to participate in the transaction. *Accord, Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822, 91 S.Ct. 41, 27 L.Ed.2d 50 (1970) ("where the success of a fraud does not require an exercise of volition by the plaintiff, but instead requires an exercise of volition by other persons, there need be no showing that the plaintiff himself relied upon the deception"); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967) ("[w]hatever need there may be to show reliance in other situations [citing *List* and other cases], we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer").

Though the specific holding in *Schlick* obviously is inapplicable given the facts of the case at bar, the portion of the Second Circuit's opinion dealing with loss causation and transaction causation *is* instructive. Ours is a case in which, to quote the majority opinion, "the complaint alleged that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Revenue Board to issue, and

the public to buy, fraudulently marketed bonds."[10] Whether this case is viewed as a misrepresentations case or an omissions case,[11] the named plaintiff and every member of the putative class voluntarily entered into the transaction as the result of an investment decision. If we adhere to *Schlick*, each must show transaction causation—including reliance (actual or presumed) on the offering circular. In this case the existence of reliance has been definitively disproved by Bishop's admission that he did not read or even seek to read the offering circular. And, as the majority opinion correct concludes, presumptive reliance has been rebutted by the same admission.

In short, neither *Schlick*, *Blackie*, nor any other case cited by the majority supports its holding. In fact, the majority's holding runs contrary to the clear implication of every case from this circuit and other [illegible] which the reliance requirement has been considered.

## III. REASONS FOR ADHERENCE TO THE RELIANCE REQUIREMENT

### *A. The Policy Behind the Reliance Requirement*

In the case at bar, the majority holds that nonreliance on the defendants' misrepresentations or omissions is not fatal to some cases brought under clauses (1) and (3) of Rule 10b-5 and creates

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[10] *Ante*, 647 F.2d at 464 (footnote and bracketed definition of terms omitted).

[11] In my view, this is primarily a misrepresentations case rather than an omissions case because the defendants undertook to sell the bonds pursuant to an offering circular. *See Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981) ("[t]his case, involving alleged misstatements and omissions in a prospectus published pursuant to a public offering, cannot properly be characterized as an omissions case of the type for which the *Affiliated Ute* presumption was fashioned"); *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713, 717 n. 2, 718 & n. 4 (8th Cir. 1978).

instead a new sort of reliance requirement for those cases—reliance on the integrity of the marketplace. Other than the majority's interpretation of the policies and the congressional purpose behind the federal securities laws,[12] there is absolutely no support for the majority's holding today in the prior precedent of this or any other court.

In part V of its opinion, the majority correctly states that "[t]he thrust of the arguments against [its] holding is that a recovery in this circumstance is not consonant with the central purpose of the securities laws, which, it is argued, is to provide full disclosure so that investors may make informed investment decisions."[13] The majority then cites phrases from a number of

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[12] Justice Rehnquist's opinion in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 95 S.CT. 1917, 44 L.Ed.2d 539 (1975), emphasizes the importance of weighing competing policy concerns:

> [W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express "intent of Congress" as to the contours of a private cause of action under Rule 10b-5. When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

*Id.* at 737, 95 S.Ct. at 1926.

[13] *Ante*, 647 F.2d at 470; MS at 16.

cases[14] for the proposition that "[f]ull disclosure is only one

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[14] The complete quote from *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), reads as follows:

> The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended, 15 U.S.C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H.R.Rep.No.85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S.Rep.No. 792, 73d Cong., 2d Sess., 1-5 (1934).

*Id.* at 195, 96 S.Ct. at 1382. Even more informative is the actual language from *Tcherepnin* v. *Knight*, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967):

> The Securities Exchange Act [of 1934] quite clearly falls into the category of remedial legislation. One of its central purposes id to protect investors *through the requirement of full disclosure by issuers of securities*, and the defintion of security in § 3(a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections.

*Id.* at 336, 88 S.Ct. at 553 (emphasis added; footnote omitted). The majority also cites *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), but that case says:

> As we have stated time and again, the purpose behind Section 10(b) and Rule 10b-5 is to protect the investing public and to secure fair dealing in the securities markets *by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets.*

*Id.* at 235 (emphasis added). And in *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970), we described Congress' intent as follows:

> In short, *Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets*, . . . and the loss resulting in connection with purchases or sales made without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b-5 seek to prevent.

*Id.* at 806 (emphasis added).

means, albeit a central one, of achieving [the] paramount goals" of the federal securities laws.[11] I disagree.

This court recognized over a decade ago that in the context of a private suit for damages,

> the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that the rule requires for its violation is that someone "do something bad" in connection with a purchase or sale of securities. Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the proscription. In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.

*Herpich* v. *Wallace,* 430 F.2d 792, 804-05 (5th Cir. 1970) (citations omitted). In an accompanying footnote, *id.* at 805 n.12, we listed the reliance requirement first among the court-made limits on civil liability under Rule 10b-5. Citing our decision in *Herpich,* with approval, the *Blue Chip Stamps* Court shared our "concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will utlimately result in more harm than good." 421 U.S. at 747-48, 95 S.Ct. at 1931.

The Supreme Court and this court have recognized that there must be limits in defining the class of persons who may recover under Rule 10b-5. The policy question presented by the case at bar is whether the traditional reliance requirement is a sensible limit in *all* cases in which the plaintiff has made an investment decision. I believe that this question must be answered in the affirmative.

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[11] *Ante,* 647 F.2d at 471.

The reliance requirement promotes the objectives of the 1934 Act by precluding recovery to a plaintiff who has made an investment decision by his own lights and without reference to the information promulgated under the disclosure requirments of the federal securities laws. Whether disclosure is viewed as a goal or as a mechanism to achieve a goal, it is crucial to the way in which the federal securities laws function. Just as the threat of litigation and massive liability under Rule 10b-5 is intended to deter fraudulent conduct connected with the purchase or sale of a security, the reliance requirement is intended to encourage investors to base their investment decisions on information required by the securities laws to be disclosed. In short, the federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves. If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated. Indeed, after reading the offering circular in this case and considering the disclosures about the weak and highly questionable financial position of ASECo that *were* made therein, I am left with the nagging question of whether Bishop would have had a loss if he had read the offering circular, latently defective as it may have been.[16]

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[16] The inadvisability of taking any action that would have the effect of minimizing or eliminating the need to read the offering circular is highlighted by the facts of this case. The offering circular may well have contained the latent material misrepresentations and omissions described at great length and in detail in the plaintiff's second amended complaint. But if the plaintiff or someone acting for the plaintiff (such as the broker form whom he bought the bonds, who is not a defendant in this case) had read the offering circular, the disclosures

Apart from the fact that the reliance requirement makes sense in the context of the objectives of the 1934 Act and the method chosen by Congress to achieve those objectives, there is another reason for not eliminating the reliance requirement in a suit under Rule 10b-5. To paraphrase Justice Stewart's opinion in *Aaron* v. *SEC*, 446 U.S. 680, 689, 100 S.Ct. 1945, 1951, 64 L.Ed.2d 611 (1980), we do not write on a blank slate in determining whether reliance is a necessary element for recovery under section 10(b) and Rule 10b-5. The basic requirements of a

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that are made in the financial statements included therein might very will have warned him of the risk inherent in the bonds and of the calibre of the people involved in the transaction pursuant to which the bonds were issued.

The second paragraph of the accountant's report on the financial statements of ASECo, Inc. as of August 31, 1972, reveals on its face that the accompanying financial statements were *not* prepared in accordance with generally accepted accounting principles:

> Investment real estate having a net book value of $473,436.66 is carried on the enclosed balance sheet at $2,420,500, an increase for statement purposes of $1,947,063.34. One parcel is supported by an appraisal dated October 12, 1971, by a member of the American Institute of Real Estate Appraisers at a value of $2,284,000.

The significance of the increase in the carrying value of the real estate "for statement purposes" in the amount of $1,947,063.34 becomes clear when we turn to the balance sheet, where the net worth of ASECo, Inc. is shown as $2,203,657.33. If we subtract from that net worth the amount wrongly included in it ($1,947,063.34), we are left with a net worth of $256,593.99. If we examine that number more closely, we find that it is based in part on three items (totaling $430,787.05) included in Current Assets under the heading "Advances to Stockholders"—one item in the amount of $176,091.40 called "Open Notes," a second item in the amount of $54,695.65 called "Used for purchase of corporate shares for company account," and a third item in the amount of $200,000.00 called "Capital Stock subscriptions receivable." The footnote to the "Open Notes" item contains the following piece of information: "Stockholders propose to liquidate a portion of these advances by assigning to the corporation their equity in residence real estate, valued at $77,000.00." The footnote to the "Used for purchase of corporate shares for company

cause of action under Rule 10b-5 (which are listed in part III of the majority opinion) have remained largely intact since the Rule was adopted. The Supreme Court has consistently turned back efforts to eliminate or water down those requirements. *E. g., Santa Fe Industries, Inc.* v. *Green, supra* (only conduct involving manipulation or deception is reached by section 10(b) or Rule 10b-5; private action under Rule 10b-5 will not lie for mere abuse of fiduciary duty); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) (private cause of action for damages will not lie under section 10(b) and Rule 10b-5 in the absence of any allegation of scienter; allegation of negligence insufficient); *Blue Chip Stamps* v. *Manor Drug Stores, supra* (private damages action under Rule 10b-5 is con-

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account" item contains this description of the transaction involved: "The stockholders obtained funds for the purpose of purchasing certain common stocks for the account of the company. We were advised that the shares have been forwarded to the registrars for registration in the company's name." Finally, the footnote to the "Capital Stock subscriptions receivable" item contains the following information: "The company is holding a note from J. C. Harrelson in which he has promised to purchase 1667 shares of capital stock in the company within sixty days of August 31, 1972."

All three of the items listed in current assets under the heading "Advances to Stockholders" would have to be viewed with *great* skepticism, particularly in view of their materiality, individually and in the aggregate, to the financial statements. And, if they are eliminated from current assets, ASECo, Inc. is insolvent.

In summary, the accountant's report included in the offering circular is irregular on its face; the financial statements included therein are highly questionable on their face and strongly suggest that ASECo, Inc. was insolvent or nearly so on the balance sheet date. The average investor in industrial revenue bonds, when presented with the accountant's report and financial statements for ASECo, Inc. would, in my view, have had a good indication that the entire transaction was questionable and extremely risky.

fined to actual purchasers or sellers of securities).[11] *Cf. Aaron* v. *SEC, supra* (SEC is required to establish scienter as an element of a civil enforement action to enjoin violations of section 10(b) and Rule 10b-5); *Chiarella* v. *United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980) (recognizing that while silence in connection with purchase or sale of securities may operate as a fraud actionable under Rule 10b-5(1) and (3), criminal liability must be premised on duty to disclose arising from relationship of trust and confidence between parties to a transaction). We do not have a license to do what the Supreme court has refused to do.

*B. The Majority's "Fraud on a Broader Scale" Exception to the Reliance Requirement*

The majority opinion contains two conflicting views of the nature of this case. The opening lines of the majority opinion describe the plaintiff's complaint as alleging "in essence . . . that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development

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[11] Indeed, of late the Court has shown marked reluctance to extend the contours of private causes of action under the securities laws generally. *E. g., Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979)(no implied private right of action under § 206 of Investment Advisers Act of 1940); *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979) (no implied private right of action under § 17(a) of 1934 Act); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977)(no implied private right of action under § 14(e) of 1934 Act; unsuccessful tender offeror lacked standing to sue for damages under Rule 10b-6); *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976) (rejecting Seventh Circuit's expansive definition of materiality in private suits under Rule 14a-9 as encompassing "all facts which a reasonable investor *might* consider important"; misstatement or omission in proxy solicitation is material only if there is "substantial likelihood" that a reasonable shareholder *would* (not "might") consider the fact important in deciding how to vote).

Board . . . to issue, and the public to buy, fraudulently marketed bonds.'"[18] But elsewhere in the opinion, the offering circular is described as "only one component of the overall scheme."[19] Following the latter view of the case, the majority opinion states that "[w]henever the rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The 'reliance' that produces causation in the latter type of case cannot come from reading a document. It may arise from . . . a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created. . . ."[20] The conflicts in the majority opinion suggest the question: What kind of a case do we really have here?

The answer to that question is clear to me. The majority opinion had it right the first time. We have a case in which the fraud on the plaintiff and the other purchasers of the bonds was effected by means of a misleading offering circular. The defendants are the participants in that offering—the underwriters who sold the bonds, the lawyers who participated in the preparation of the offering circular, the accounting firm that rendered a report on the financial statements included in the offering circular, the bank that acted as a trustee under the mortgage securing the bonds, and various persons who are alleged to have aided and abetted the issuer of the bonds and controlling persons of the issuer. While the plaintiff's second amended complaint chronicles at length and in detail the manner in which the proceeds of the bonds were allegedly dissipated or diverted, the essence of the fraud insofar as the plaintiff and other bond purchasers are concerned consisted of the sale of bonds to the

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[18] *Ante,* 647 F.2d at 464.

[19] *Ante,* 647 F.2d at 469.

[20] *Ante,* 647 F.2d at 472.

public by means of a misleading offering circular. The "shift" in the Rule 10b-5 issue described in the majority opinion to "fraud on a broader scale" is a shift effected by the majority in order to avoid the result otherwise mandated by the application to this case of the traditional elements of a private cause of action under Rule 10b-5. The majority's only justification for the shift is that Bishop's complaint, like all Rule 10b-5 complaints, tracks the language of the entire Rule and urges the applicablity of clauses (1) and (3).[21]

The majority correctly makes the point that the Rule is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents. It goes on to say that the Rule (meaning, presumably, clauses (1) and (3) of the Rule) is "recognized" to provide the basis for a federal cause of action for "fraud on a broader scale" or "more elaborate, intentional schemes which deceive or defraud purchasers of securities."[22] That statement is wrong. No other court has applied clause (1) or (3) of the Rule on the basis of the scale or elaborateness of the scheme to defraud. As the very cases cited by the majority demonstrate, clauses (1) and (3) of the Rule have been applied instead to cases in which the fraud is not covered by clause (2) of the Rule—*i. e.*, to total omissions cases, such as *Utc*, or to cases, such as *Schlick*, in which the fraud is accomplished by means of what the defendants did (*e.*

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[21] It does not appear that Bishop argued *any* of the majority's theories—his entitlement to rely on the integrity of the market, the bonds' lack of entitlement to be marketed, or the fraud on a broader scale—in the district court. These theories are not mentioned at all in the district court's memorandum opinion.

[22] *Ante*, 647 F.2d at 472.

g., manipulated the market) rather than by means of what they said.[23]

To permit the plaintiff in a case clearly covered by clause (2) of the Rule to fall back on the broad language of clause (1) (which reaches schemes to defraud) or clause (3) (which reaches acts that operate as a fraud), in combination with allegations of elaborate collateral conduct, in order to obviate the effect of the failure to comply with the reliance requirement under clause (2), makes the reliance requirement of clause (2) a dead letter in the one situation in which it most typically applies—the offering of a security, pursuant to an offering circular, to investors who are called upon to make routine investment decisions. The majority notes in footnote 5 of its opinion that to do away with the reliance requirement in a Rule 10b-5(2) case could establish a scheme of investors' insurance, which numerous courts have held was not the intent of section 10(b). Yet, given the scienter requirement, it is difficult to conceive of conduct actionable under clause (2) of Rule 10b-5 that is not also actionable under

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[23] One leading commentary on the securities laws suggests that a distinction should be drawn between those situations in which the defendants themselves did something to the plaintiff and those situations in which the defendants induced the plaintiff to do something by means of a misrepresentation or omission of a meterial fact:

> Where the gravamen of the action is something other than misrepresentation or non-disclosure, then of course the question of reliance does not arise. For example, if the complaint is that the defendant sold $5,000,000 of securties belonging to the corporation and pocketed the proceeds, or used them to pay for a controlling block of the corporation's stock, as in [*Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971)], it makes no sense to ask whether anyone relied upon anything. *The complaint is about what the defendant did, not what he said or didn't say.*

R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 1064 (4th ed. 1977) (emphasis added). This distinction is in accord with my discussion of the *Schlick* case in part II-*C* above.

the broader language of clauses (1) and (3). The majority's holding threatens to turn all of Rule 10b-5 into a scheme of investor's insurance—at least where the security offered can be shown to be not "entitled to be marketed"—and it does so in-what is, insofar as the plaintiff is concerned, an ordinary transaction flowing from his voluntary investment decision to purchase a security.

In my view, clauses (1) and (3) of the Rule were drafted broadly so as to reach fraudulent behavior by defendants that is not covered by the literal language of clause (2). But clauses (1) and (3) should not be used, as they are by the majority, to obviate for a plaintiff any of the traditional proof requirements of a cause of action under clause (2).

The majority opinion is a harginger of difficulties for future securities litigation. Surely ingenious plaintiffs' counsel will hereafter plead the "entitled to be marketed/fraud on a broader scale" theory at least as an alternative basis for recovery. The question whether a security was "entitled to be marketed," *i. e.*, whether the security, absent the fraud, could have been sold at some price, and the question whether the scale of the fraud was broad enough, are both presumably questions of fact, not readily disposed of by summary judgment. The creation of this new recovery theory will not only breed more litigation, but it will also make that litigation more difficult and time consuming. Whether the end result will by any different can be determined only be seers.

The length to which the majority goes to preserve a remedy in federal court for Bishop suggests that Bishop and others like him who did not rely on the offering circular might otherwise be without a remedy. In fact, if what he alleges in his complaint is true, Bishop had a remedy under Rule 10b-5 against his broker, upon whom he did rely and who advised him that the bonds were a good investment. He chose, for reasons known only to him, not to sue his broker. Surely his election not to sue the per-

son against whom he had a legitimate Rule 10b-5 claim and instead to sue those against whom recovery under Rule 10b-5 has heretofore been precluded should not result in this court's fashioning new law for his benefit. Further, the scheme to defraud that Bishop describes clearly constitutes common law conversion and would be actionable in state court. There is, therefore, no necessity in this case to create a new route to recovery under Rule 10b-5 in order to provide a remedy in federal court for Bishop and others like him who, by their own actions, have forfeited the protection of the Rule.

For the foregoing reasons, I would affirm the decision of the district court granting summary judgment in favor of the defendants.

## APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

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CA75-H-618-S

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Clarence E. Bishop, Jr., Etc.,
Et Al.,
Plaintiffs,

vs.

Jerald H. Sklar, Et Al.,
Defendants.

## MEMORANDUM OF DECISION

This action is before the court on the several pending motions of the defendants which motions collectively raise numerous grounds common to some, if not all, of the defendants; consequently the court will consider each motion as having raised each ground and each defendant as having joined in each motion. Furthermore, the motions themselves, the extensive and excellent briefs of counsel, and the oral argument heard herein have raised certain material issues which have a direct bearing on the ultimate disposition of the motions. Thus, the court will be required to consider matters outside the pleadings to resolve the motions and attendant issues. Accordingly, pursuant to Rule 12(b) of the Federal Rules of Civil Procedure, the motions to dismiss shall be treated as motions for summary judgment and disposed of as provided in Rule 56.

The initial complaint in this action was filed on May 16, 1975. During the next several months numerous motions, affidavits

and discovery documents were filed culminating in an order entered on September 8, 1975, allowing the plaintiff to file an amended complaint. The plaintiff filed the "First Amended Complaint" on September 8, 1975. That filing set off a second round of motions, affidavits and discovery papers. On December 29, 1975, an order was entered dismissing all claims under the Securities Act of 1933 (15 U.S.C. §77a et seq.) and, treating the numerous motions to dismiss as motions for more definite statement, directing that the plaintiff file a second amended complaint within 120 days. This time period was later extended to June 1, 1976, at plaintiff's request. The "Second Amended Complaint" was filed on June 9, 1976.

Not surprisingly, the filing of the Second Amended Complaint initiated a third round of motions and affidavits. Desiring either to resolve the issues presented or at the very least to move this action past the "motion to dismiss stage" where it had been stalled for approximately a year and a half after the initial complaint was filed, the court set the action down for special hearing on September 24, 1976. Subsequent to the September hearing, and the extensive oral argument presented at that time, the court set out an extended briefing schedule. At the requests of the parties, the briefing schedule was further extended, and while the briefing period is now concluded, the court is still receiving supplemental briefs. In any event, the court now has before it the pleadings, the motions with supporting documentation, the submitted briefs and supplements thereto, and the benefit of exhaustive oral argument of counsel and considers the issues to be ripe for a decision.

The Second Amended Complaint filed by the plaintiff, Clarence E. Bishop, Jr., both individually and on behalf of a described class of persons charges the defendants with violations of the Securities Exchange Act of 1934 (15 U.S.C. §§78a et seq.) and further invokes the pendent jurisdiction of this court to add a state cause of action for fraud.

**Plaintiff Bishop's Individual Action**

The plaintiff maintains that all his claims in the complaint are predicated on actions by the various defendants, either separately or in conjunction with one another, prior to, concurrent with, and/or subsequent to the issuance and/or sale of $1,500,000 principal amount of The Industrial Development Board of the Town of Frisco City, Alabama ("Board") First Mortgage Revenue Bonds, Series A, dated November 1, 1972 ("Bonds"). The Bonds were authorized and issued as coupon bonds in the denomination of $1,000 each, numbered serially from 1 to 1,500, and were to mature serially over a period of 20 years. Interest on the Bonds was to be paid semi-annually at varying coupon rates. The Bonds were issued and sold in three equal increments of $500,000 each to defendant Jackson Municipals, Inc. which served as underwriter for the Bonds. The sale of the first increment of the Bonds occurred on November 28, 1972 (or December 14, 1972); the second increment was sold on January 3, 1973; and the third and final increment of Bonds was sold on January 30, 1973.

The Bonds were issued by the Board to finance the construction and equipping of a manufacturing plant ("Plant") to be occupied by Alabama Supply and Equipment Company ("ASECO") under a long term lease ("Lease") from the Board. The rent ASECO was to pay was an amount calculated to amortize and retire the principal and interest on the Bonds. The Bonds were to be payable solely from the proceeds derived from the Lease and were secured by a Mortgage, Indenture of Trust and Security Agreement dated as of November 1, 1972 ("Indenture") from the Board to Phenix National Bank, Phenix City, Alabama ("Trustee Bank"), which is now the First Alabama Bank of Phenix City. The statutory authorization for the issuance and sale of the Bonds, the construction and leasing of the Plant, the execution of the Indenture and the general proceedings associated therewith is one of two general methods of municipal industrial development financing and is found in Sec-

tions 815, et seq. of Title 37 of the Code of Alabama, which statutory authority is commonly referred to as the Cater Act.

On January 19, 1973, plaintiff Bishop purchased from Professional Securities, Inc. (which is not a defendant herein) Bonds numbered 593, 594 and 595 and on February 12, 1973, he purchased from the same source a fourth Bond serially numbered 619. Plaintiff paid par ($1,000) for each of the four Bonds, plus interest accrued thereon from the date of each Bond, November 1, 1972, to the date of purchase. Each of these four Bonds was a part of the second increment of Bonds sold January 3, 1973. He still owns each of the four Bonds.

As stated earlier, the motions before the court are addressed to the third effort of plaintiff to state a claim upon which relief can be granted. This effort, the "Second Amended Complaint," carefully divides the defendants into various groups and endeavors to state claims against all defendants in three counts.[1] *Count I* attempts to state a cause of action for violation of Section 10(b) of the 1934 Act and of Rule 10b-5 promulgated in connection therewith, and this court clearly has jurisdiction over this cause of action and the parties thereto. In essence it charges that the Bonds were sold by means of an Offering Circular which contained untrue statements of material facts and which omitted material facts which are necessary and that the defendants were responsible for the false statements and omissions in the Offering Circular.[2] *Count III* is a wholly state law based caused of action for fraud. There is no independent basis for this court to entertain jurisdiction over the parties

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[1] It may be that the "Candler Defendants" are not intended to be defendants to Count I. Clearly all other defendants are included in Count I and all defendants are joined in Count II and Count III.

[2] The court here assumes, without deciding, that the requisite mental state or scienter has been alleged, although with regard to most of the defendants this may well be an unfair assumption. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

to and cause of action stated in Count III. Thus jurisdiction, if it exists, is pendent to the Rule 10b-5 action stated in Count I.[3] *Count II* really adds nothing to the complaint. It simply alleges a "conspiracy" by the defendants to violate Rule 10b-5 or to commit common law fraud or to do both.

While Count I alleges that the Bonds were sold by means of an Offering Circular which contained untrue statements of material facts or which ommitted to state material facts which were necessary, it totally fails to allege that plaintiff Bishop relied upon the Offering Circular when he purchased his four $1,000 Bonds. Were the court dealing with a mere oversight in pleading, the matter would be simple—plaintiff would be permitted to amend and allege reliance. But the failure to allege reliance has been repeatedly driven home to plaintiff for an entire year and he has failed to endeavor to amend. The reason for this failure, as will be discussed hereafter, is that Mr. Bishop did not rely on the Offering Statement, except perhaps in a most indirect manner. Thus the instant action squarely raises the issue of the extent to which reliance is a necessary element in a private securities fraud action. Plaintiff, relying primarily upon *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972), asserts that to the extent that reliance is an element, that element is present. Defendants, quite naturally, take a contrary view.

Much of the controversy surrounding the question of reliance is predicated upon the difficulty of proving reliance in omission as opposed to misrepresentation cases and open market versus face-to-face transactions. See, 2 Bromberg, *Securities Law,* §8.6(1)-(2), pp. 209-212; Jennings and Marsh, *Securities*

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[3] It will not be necessary for the court to resolve the serious jurisdictional question applicable to some defendants, primarily Trustee Bank and the "Candler Defendants." But clearly if they are not proper defendants under Count I, this court would not have jurisdiction of the Count III claim against them. *Aldinger* v. *Howard,* 427 U.S. 1 (1976).

*Regulation,* 4th ed., pp. 1060-1068 (1977). No such difficulty is presented in the instant action.

All of the plaintiff's allegations of fraudulent misrepresentations or omissions are focused on the Offering Circular prepared in connection with the initial sale of the Bonds and, as noted earlier, Mr. Bishop purchased four Bonds at par in a face-to-face transaction from a broker who is not a defendant. The Second Amended Complaint, however, in no way can be construed as alleging that Mr. Bishop relied upon the Offering Circular (and hence was defrauded by any false statements or omissions therein), and as a matter of fact, as will be discussed hereafter, Mr. Bishop never saw the offering Circular, AESCO, the Plant, the Board, the Lease or the Indenture, and did not rely on the Offering Circular. Thus, for the purpose of the pending motions the court can assume that every statement in the Offering Statement was material and false and that there was omitted from the Offering Statement numerous statements of material facts necessary to be made in order to make the statements therein contained not misleading. For the real issue is whether a private securities fraud action will lie under Rule 10b-5 or whether a common fraud action will lie under state law in the face of an affirmative denial by the plaintiff of any reliance on the alleged fraudulent statements or omissions. The answer is clear. Neither such action will lie and plaintiff may not recover.

On August 19, 1975, defendants Thomas E. Martin, Robin B. Page and Joseph F. Savage, propounded a set of interrogatories to plaintiff Bishop. On March 26, 1976, Mr. Bishop filed his sworn answers to those interrogatories. The following questions were asked and answers given:

[Question]

> I. MPS-17. Did plaintiff have any communications (oral or written) with anyone about TCC, the Offering Circular, ASECO and/or the Bonds?

[Answer]

I. MPS-17. I did not have any communications with anyone about TCC. I never saw the Offering Circular or Offering Statement that has been identified to me by my attorneys. I had no communications with anyone about "ASECo". I did talk to Tom Monks at the time I purchased the bonds.

[Question]

I. MPS-18. If the answer to Interrogatory I. MPS-17 is in the affirmative:

(a) Identify each person with whom each such oral or written communication was held;

(b) Identify each person who was present during each such oral communication;

(c) State the date of each oral communication and where it took place;

(d) Set forth substance of what each person stated at each such communication and identify the speaker;

(e) Identify the person who initiated the topic referred to above in any oral communication;

(f) Identify each document which refers to, related to, records or evidences each such oral communication;

(g) Identify each written communication giving its date, author and all recipients thereof.

[Answer]

I. MPS-18 (a) Tom Monks who was president of Professional Securities, Inc., 1620 - 10th Avenue South, Birmingham, Alabama 35205.

(b) Mr. Monks' secretary, whom I do not know.

(c) Immediately prior to the purchase of the first bonds and later when I made the second purchase. These communications were in Mr. Monks' office and by telephone.

(d) Mr. Monks advised me that these were tax free bonds and a good investment. He also told me about other people in the community who had purchased them.

(e) Mr. Monks.

(f) The confirmation of sales on the two purchases.

• • •

[Question]

I. MPS-28. Identify each document which plaintiff saw prior to making the acquisition and/or of which plaintiff was aware (even if plaintiff did not see it) which related to the Bonds, TCC and/or the acquisition and for each such document:

• • •

[Answer]

I. MPS-28. I did not see any or have knowledge of any, nor was I aware of any such document.

• • •

[Question]

I. MPS-34. Did plaintiff discuss plaintiffs' acquisition of the Bonds or the Offering Circular with anyone?

[Answer]

I. MPS-34 and 35. I may have casually mentioned the purchase of the bonds in conversation with friends or acquaintances. There was never any discussion other than a passing reference to the purchase of the bonds. There was no discussion of the bonds in the sense called for by the question. I am unable to recall, definitely, any specific per-

son or occasions when I even occasionally mentioned the bonds.

Thus the plaintiff has affirmatively denied seeing or relying on the Offering Circular that is the crux of the alleged fraudulent misrepresentations and omissions. In the light of a specific disavowal of reliance, plaintiff cannot prevail. And *Simon* v. *Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 482 F.2d 880 (5th Cir. 1973), specifically rejects plaintiff's argument that *Affiliated Ute, supra,* eliminated the element of reliance in securities fraud action. The court held "that some element of general reliance, even in nondisclosure cases, is essential to a Rule 10b—5 action . . . . The circuit's requirement of reasonable reliance, therefore, was not met." 482 F.2d at 884-85. The essentiality of the reliance element was reaffirmed in *Vohs* v. *Dickson,* 495 F.2d 607, 622 (5th Cir. 1974), where the court again concluded that even in instances of alleged fraudulent omissions a general reliance must be shown. In the instant action plaintiff has specifically denied *any* reliance — general or specific. He has denied seeing the Offering Circular, he has denied talking with anyone about ASECO; or, indeed, inquiring about the Bonds other than being told that they were tax free and a good investment.

The securities laws were not intended to be an absolute insurance policy to investors. The purpose of the laws is to prevent fraud of the reasonable and prudent investor, they were not intended to protect investors from their own shortcomings or failures to inquire and investigate. Private securities violations are predicated on fraud and the necessary elements must be plead and proven or no recovery will lie. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). Also see FRCP Rule 9(b).

The plaintiff herein in a sworn statement has denied that he relied on the Offering Circular or on any significant oral representation. Moreover, he cannot successfully argue any

"open-market" relaxation of the reliance requirement[4] because he purchased his Bonds, at par, over-the-counter, as a part of the distribution of an initial issue and not in any secondary market or on a national securities exchange. Some form of reliance is an essential element of a Rule 10b-5 action. *Simon* v. *Merrill Lynch, Pierce, Fenner and Smith, Inc., supra; Vohs* v. *Dickson supra.* No form of reliance is present here. There is no genuine issue as to any material fact concerning the absence of reliance and the defendants are entitled to a judgment as a matter of law against plaintiff Bishop under Count I. Because reliance is also a required element of both common law fraud, see, Prosser, *Law of Torts* 4th ed., §108 (1971), and statutory fraud or deceit in Alabama, see e.g., *Hudson* v. *Moore,* 239 Ala. 130, 194 So. 147 (1949); *Old Southern Life Ins. Co.* v. *McConnell,* 52 Ala. App. 589, 296 So.2d 183 (1974), defendants are also entitled to a judgment as a matter of law against plaintiff Bishop under Count III. Necessarily a judgment against plaintiff Bishop on Counts I and III will mandate a similar judgment under Count II.

**Class Action Matters**

Plaintiff Bishop, as the only named representative of the class, also pursues this action on behalf of a purported class consisting of "all . . . persons who, to their injury and damage, purchased First Mortgage 8% Revenue Bonds, Series A, . . . issued by The Industrial Development Board of the Town of Frisco City, Alabama." The fact that Mr. Bishop cannot prevail on his individual action does not prevent him from pursuing the class aspect of this action, provided that the action may otherwise proceed as a class action. And while even the claims of the class, as a pure pleading matter, should be dismissed as totally lacking in the necessary allegations of reliance, the court is of

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[4] See *Blackie* v. *Barrach,* 524 F.2d 891 (9th Cir. 1975). But see *Little* v. *First California Company,* 532 F.2d 1302 (9th Cir. 1976).

the opinion that the class questions should be more directly addressed.

There is no question that securities fraud actions are often well suited for treatment as class actions. "On the other hand, although having some common core, a fraud case may be unsuited for treatment as a class action if there was material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed." *Advisory Committee Report on the Proposed Amendments to the Rules of Civil Procedure,* 39 F.R.D. 69, 103 (1966). And before permitting a suit filed under Rule 23 of the Federal Rules of Civil Procedure to be maintained as a class action, the court must be satisfied that the prerequisites of Rule 23 have been met. Plaintiff has not so satisfied the court.

Absence of typicality and adequate representation are apparent, and there is nothing before the court upon which it can conclude that common questions of fact predominate. Plaintiff twice has been afforded the opportunity completely to amend the complaint; has had over two years to engage in discovery; and has been reminded time after time by defendants during the past year of the total absence in the complaint of any allegation of reliance, not only as to Mr. Bishop but also as to the class he seeks to represent. He has not endeavored to determine the extent to which, if at all, any member of the putative class may have relied on the Offering Statement. Indeed, he has not communicated with any class member. See plaintiff's March 26, 1976 answers to interrogatory I. MPS-22 propounded August 19, 1975 by defendants Martin, Page and Savage. The evident lack of interest of plaintiff in determining if any other purchaser saw the Offering Circular or relied in any manner thereon is best understood by Mr. Bishop's personal interest in pursuing his own claim, where reliance was non-existent, in a manner inconsistent with the possible claims of putative class members who may have relied upon the Offering Circular, albeit in significantly varying degrees and circumstances. Accordingly,

pursuant to Rule 23(c) a separate order will be entered prior to the judgment against plaintiff Bishop that this action shall not be maintained as a class action. Because this Rule 23(c) determination is being made over two years after the action was filed (it took plaintiff over a year to finally draft a complaint which he wanted to rest on, it took the parties six months to brief the issues and it took the court over six months to resolve the issues), statutes of limitations may adversely affect individual rights of the putative class. Accordingly, the order to be entered will expressly authorize any putative class member, within six months after the entry of such order, to petition the court to intervene in this action to pursue his *individual* claim. Jurisdiction will be retained for the limited purpose of considering such a petition and, where the petitioner satisfies the court that he failed to pursue his individual claim in reliance upon this action being pursued for his benefit, the intervention will be allowed as if it had preceded the Rule 23(c) determination. This retention of jurisdiction for the limited purpose of possibly adding additional parties plaintiff shall not affect the finality or appealability of the judgment to be rendered against plaintiff Bishop since under Rule 54(b) the court expressly determines that there is no just reason for delay and expressly directs the entry of such final judgment.

An appropriate order and an appropriate judgment will be entered.

DONE this 2nd day of August, 1977.

/s/ James H. Hancock
UNITED STATES DISTRICT JUDGE

## FINAL JUDGMENT

In accordance with the Memorandum of Decision entered this day it is hereby

ORDERED, ADJUDGED and DECREED that plaintiff Clarence E. Bishop, Jr. have and recover nothing of defendants.

Costs are taxed against the plaintiff.

DONE this 2nd day of August, 1977.

/s/ James H. Hancock
United States District Judge

## APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT
UNIT B

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No. 77-2896

---

D. C. DOCKET NO. CA 75-H-618-S

James L. Shores, Jr., as Executor of the Estate of Clarence E. Bishop, Jr., Etc., Et Al.,
Plaintiffs-Appellants,

versus

Jerald H. Sklar, Et Al.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Alabama

Before BROWN, COLEMAN, AINSWORTH, CHARLES CLARK, RONEY, GEE, TJOFLAT, HILL, FAY, RUBIN, KRAVITCH, FRANK M. JOHNSON, Jr., GARZA, HENDERSON, REAVLEY, POLITZ, HATCHETT, ANDERSON, RANDALL, TATE, SAM D. JOHNSON, and THOMAS A. CLARK, Circuit Judges.*

### JUDGMENT ON REHEARING EN BANC

This cause came on to be heard on the petition for rehearing en banc of the appellees, and was argued by counsel;

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* Chief Judge Godbold and Judge Vance were disqualified in this case. Judge Williams does not wish to participate in the decision.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court en banc that the judgment of the District Court in this cause be, and the same is hereby vacated; and that this cause be, and the same is hereby remanded to the said District Court in accordance with the opinion of this Court;

IT IS FURTHER ORDERED that the appellees pay to the appellants the costs on appeal, to be taxed by the Clerk of this Court.

May 26, 1981

RANDALL, Circuit Judge, with whom Judges Brown, Roney, Gee, Tjoflat, Hill, Fay, Rubin, Reavley and Hatchett, Circuit Judges, join, dissenting.

**APPENDIX D**

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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No. 77-2896

---

James L. Shores, Jr., as
Executor of the Estate of
Clarence E. Bishop, Jr., Etc.,
Et Al.,
Plaintiffs-Appellants,

versus

Jerald H. Sklar, Et Al.,
Defendants-Appellees.

---

Appeal from the United States District Court for the
Northern District of Alabama

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**ON PETITION FOR REHEARING**

(August 3, 1981)

Before BROWN, COLEMAN, AINSWORTH, CHARLES CLARK, RONEY, GEE, TJOFLAT, HILL, FAY, RUBIN, KRAVITCH, FRANK M. JOHNSON, Jr., GARZA, HENDERSON, REAVLEY, POLITZ, HATCHETT, ANDERSON, RANDALL, TATE, SAM D. JOHNSON and THOMAS A. CLARK, Circuit Judges.*

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* Chief Judge Godbold and Judge Vance were disqualified in this case. Judge Williams does not wish to participate in the decision.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ Charles Clark
United States Circuit Judge

# APPENDIX E

## Statutes Involved

Securities Exchange Act of 1934, §10(b) Manipulative and Deceptive Devices:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase of sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Commission Rules:

> "Rule 10b-5 Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

# Opposition

Office - Supreme Court, U.S.
FILED
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No. 81-839

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

JERALD H. SKLAR, *et al.*,
*Petitioners,*

v.

JAMES L. SHORES, JR., EXECUTOR OF THE ESTATE OF CLARENCE E. BISHOP, JR.,
*Respondent.*

## BRIEF IN RESPONSE TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

W. EUGENE RUTLEDGE
RUTLEDGE AND YEAROUT
1020 First Alabama Bank Building
Birmingham, Alabama 35203
(205) 322-8761
*Attorney for Respondent*

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# No. 81-839

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

---

JERALD H. SKLAR, *et al.*,
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v.

JAMES L. SHORES, JR., EXECUTOR OF THE ESTATE OF CLARENCE E. BISHOP, JR.,
*Respondent.*

---

## BRIEF IN RESPONSE TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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### STATEMENT OF THE CASE

The petitioners' statement of the case is, in the opinion of respondent, so slanted toward supporting the position of the petitioners that respondent is required to restate the case.

Respondent is the executor of the estate of Clarence E. Bishop. Bishop purchased in 1972 and 1973 four First Mortgage Revenue Bonds of the Industrial Development Board of Frisco City, Alabama. These bonds were issued pursuant to the Wallace-Cater Act, codified in §11-54-80, *et seq.*, Code of Alabama (1975). These bonds are tax-exempt[1] and are used for the purpose of allowing a local industrial development board to build an industrial facility which it can then lease to a commer-

[1] Code of Alabama (1975), §11-54-87, 11-54-96.

cial enterprise.[2] The sole source for the payment of interest and repayment of principal of the bonds is the lessee's rent payment.[3] The municipality is not liable for any payment on such bonds.[4] The rental payments are calculated to amortize the principal and interest and if the lease payments are not made neither the principal or interest is paid to the bond holders, except from the possible sale of the facility.

Petitioners are the professionals connected with the organization of the Industrial Development Board of Frisco City, Alabama,[5] the issuance and administration of the bond issue.[6]

The lessee of the premises constructed with the proceeds of the sale of the bonds, Alabama Supply and Equipment Company, defaulted almost immediately in the lease payments. The value of the bonds dropped precipitously.[7]

Bishop brought suit on behalf of himself and a class of all other purchasers of these bonds under Rule 10b-5 against those involved with the issuance of the bonds. Bishop stated his claim in two ways: (1) charging a violation of Rule 10b-5(2) in that the bonds were sold by means of a materially false and misleading offering circular and (2) charging a violation of Rule 10b-5(1) and (3) in that the bonds were marketed as a result of an elaborate fraudulent scheme designed to create a bond issue that

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[2] Id. §11-54-87

[3] Id. §11-54-89

[4] Id. §11-54-92

[5] The lawyers who are petitioners here organized this industrial development board for the specific purpose of issuing their bond issue. 647 F. 2d at 465.

[6] The principal of the lessee, J. C. Harrelson, was not made a defendant as he was murdered after the lessee defaulted on the lease and before this action was filed.

[7] Several years after the bonds were sold the bond holders received $373.33 per $1,000.00 bond from the sale of the industrial facility.

would appear genuine but was so lacking in basic requirements that the bonds would never have been approved by the industrial development board and thus never marketed at all had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other participants were perpetrating a fraud.[8] The actionable conduct of each participant was set out at length in the second amended complaint,[9] but it basically charged that the actions of petitioners were directed toward making the lessee appear to have net assets when it had none and to be experienced in the mobile home manufacturing business when it was not. Since the repayment of the bonds depended entirely on the lessee's business success and assets these were the crucial factors.

Bishop answered interrogatories before he died and admitted that he had never seen the offering circular in this case.

The district court granted summary judgment for all defendants on the second amended complaint on the basis that Bishop had not relied on the misrepresentations in the offering circular. The "fraud on the market" theory was argued to the district court, but rejected.

The Fifth Circuit reversed in an opinion by a three member panel of that court.[10] This opinion held that if the plaintiff had claimed no more than misrepresentations in the offering circular his complaint would have been properly dismissed because of his admissions that he did not see the offering circular. However, this opinion held that plaintiff's allegations of the pervasive fraudulent scheme which alone caused the bonds to be marketed alleged a "fraud on the market" claim which allowed

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[8] 647 F.2d at 468.

[9] The opinion of the circuit court below sets out these allegations, 647 F.2d 465-467.

[10] *Shores* v. *Sklar*, 610 F.2d 235 (5th Cir. 1980).

plaintiff to proceed beyond the pleading stage to attempt to prove his claims.

Only one of the petitioners, the lawyer Jerald H. Sklar and his law firm, applied for a rehearing and a rehearing *en banc*. The Fifth Circuit granted a rehearing *en banc* and the opinion which petitioners now seek to review was the result.

The majority opinion held that under the allegations of the second amended complaint the plaintiff had alleged a cause of action under Rule 10b-5(1) and (3). The majority held:

> "...The requisite element of causation in fact would be established if Bishop proved the scheme was intended to and did bring the bonds onto the market fraudulently and proved he relied on the integrity of the offerings of the securities market. His lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative. 647 F. 2d at 469.

The Court below set out the burden of proof the plaintiff must meet to recover:

> "Bishop has alleged the necessary elements of an action under 10b-5(1) or (3)... Bishop's burden of proof will be to show that (!) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) Bishop reasonably relied on the bonds availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud, he suffered a loss" 647 F.2d at 469-470.

## REASONS FOR DENYING THE WRIT

The Fifth Circuit by the opinion of the court has done nothing more than adopt a limited "fraud on the market" theory of recovery under Rule 10b-5. The Fifth Circuit has decided, after a thorough consideration of the matter, to adopt a much more limited version of this theory than has been adopted by the Second and Ninth Circuits. The Fifth Circuit will apply under the holding in this case, the "fraud on the market" theory only when the plaintiff can prove the security would not have been marketed *at all* except for the alleged fraud, while the Second and Ninth Circuits will allow recovery when the fraud has merely affected the *price* of the security.

This conservative approach to the application of Rule 10b-5(1) and (3) to securities fraud should not be reviewed. The petitioners understandably desire to escape the possible consequences of their alleged fraudulent conduct which may be the result of proceeding to trial on these claims. However, the claims made by the petitioners as to the radical nature of this opinion by the Fifth Circuit are without foundation.

### Limited Nature Of The Majority Opinion

The petitioners urge that the Court grant their Petition for a Writ of Certiorari on the basis that the opinion of the Fifth Circuit creates a "novel" basis of recovery under Rule 10b-5 which is contrary to Fifth Circuit precedent and directly contrary to the Eighth Circuit case of *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978).[11] Petitioners tell this Court that the opinion "tends to defeat the primary objective of Rule 10b-5" and that unless this Court grants the writ and reverses the Fifth Circuit the volume of Rule 10b-5 litigation in federal courts will be greatly increased. Further, that Rule 10b-5 litigation will be more protracted because "much 10b-5 litigation that would otherwise be terminated at the summary judgment stage" will now require further consideration.[12]

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[11] Petition for Writ, pp.7-8

[12] Id at p. 6

The petitioners correctly point out that there was a "vigorous dissenting opinion." This dissenting opinion suggests that the majority opinion adopts a new theory of recovery in federal courts under Rule 10b-5 which is "completely without supporting precedent" and "conflicts with the prior decisions of this and *every other circuit* and with the clear implication of recent Supreme Court decisions in the securities field." (Emphasis added).[13]

There is an unhappy note of hysteria in these claims. One has visions of the federal courts being inundated with formerly invalid claims by undeserving plaintiffs which would have prior to this opinion been rudely ejected without much ado, but which now must be patiently heard to the end, all resulting in the subversion of the primary purpose of Rule 10b-5. This case has been hard fought, both by counsel and by the Fifth Circuit internally as shown by the final vote, and this may have resulted in a distorted view of the significance of the opinion by those who lost that fight.

A more dispassionate view of the significance of this opinion is that of the only federal court that has seen fit to cite it as of the date of this brief. In *Kennedy v. Nicastro,* 517 F. Supp. 1157 (N.D. Ill. 1981) the court found that three circuits had adopted a "fraud on the market" theory of recovery under Rule 10b-5 and that the theory adopted by the Fifth Circuit in *Shores* v. *Sklar* was the most limited of the "fraud on the market" theories adopted by any of those three circuits. The *Kennedy* court describes the opinion in *Shores* v. *Sklar* as *follows*:

> In *Shores* v. *Sklar* the Fifth Circuit, with ten judges dissenting in an en banc opinion, most recently accepted only a limited version of the fraud on the market theory. It

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[13] 647 F.2d at 472

upheld such a Rule 10b-5 action only if the securities were proved entirely unmarketable-if the bonds involved could not even have been *offered for sale* on the market but for the fraudulent misrepresentation of defendants. As the Court went on to state:

> If he proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than they would never have been issued or marketed, he cannot recover. (Emphasis in original)[14]

This view of the meaning and effect of the opinion by a dispassionate judicial observer is, of course, correct. The Fifth Circuit merely held in this opinion that a limited "fraud on the market" theory of recovery in Rule 10b-5 cases would be adopted in that circuit. Judge Charles Clark, the author of the opinion, clearly stated in the opinion that the source of the right of action the plaintiff sought to enforce, and which the opinion in this case allows him to prove if he can, was the language of Rule 10-b5(1) and (3).[15] The majority refused to adopt the view of the dissenting opinion that all Rule 10b-5 litigation should be governed by ¶5(2) of that rule.[16] The majority was clearly correct in rejecting such a view as it is contrary to the clear state-

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[14] 517 F. Supp. at 1159

[15] 647 F.2d at 471

[16] Id. at 471-472:

> The most significant common thread in all these precedents is that rule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer. The rule is recognized also to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities." (472)

ment of this Court in *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128 (1972).[17]

**Supporting Precedent**

The petitioners and the dissenting opinion are also incorrect in taking the position that the opinion in this case is contrary to the precedents of the Fifth Circuit and every other circuit. In *Rifkin* v. *Crow*, 574 F.2d 256 (5th. Cir. 1978), the court points out that the Fifth Circuit had not yet decided whether it would adopt a "fraud on the market" theory.[18] The decision in *Shores* v. *Sklar* to adopt a limited version of the "fraud on the market" theory in the Fifth Circuit is neither novel or contrary to precedent. The fact that the decision was made *en banc* is obviously a reflection of the thinking of a majority of the circuit.

The case of *Competitive Associates, Inc.*, v. *Laventhal, Krekstein, Horwath & Horwath, et al.*, 516 F.2d 811 (2nd Cir. 1975), establishes that the Second Circuit is in agreement with the Fifth Circuit on the principles stated in *Shores* v. *Sklar*. The

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[17] This Court stated in the *Ute* case:

> We conclude, however, that the Court of Appeals erred when it held that there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by Gale and Haslem. 431 F2d at 1348. We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact. The first and third subparagraphs are not so restricted. These defendants' activities, outlined above, disclose, within the very language of one or the other of those subparagraphs, a 'course of business' or a 'device, scheme, or artifice that operated as a fraud upon the Indian sellers." (406 US at 152-153)

[18] The court in *Rifkin* stated:

> "This Circuit has not yet decided whether reliance should be presumed in 'fraud on the market' situations. Without full development of the facts, we need not now decide whether such a theory will be recognized in this Circuit." 574 F.2d at 263-264

*Competitive Associates* court stated the Second Circuit view of the reach of Rule 10b-5 as follows:

> However, as this court made quite clear in the *Schlick* case in which the district court's dismissal of plaintiff's complaint was reversed, a showing of reliance is not required where a comprehensive scheme to defraud which includes not only omissions and misrepresentation, but substantial collateral conduct as well, is alleged. 507 F.2d at 380-381. *Not every violation of the antifraud provisions of the federal securities law can be, or should be, forced into a category headed "misrepresentations" or "non-disclosures." Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws.* In the case before us, plaintiff has charged the accounting defendants not only with affirmative misrepresentations in the financial statements, but also with a failure to disclose the true financial condition of Takara Partners and the alleged receipt of pay offs in return for its certification; furthermore, both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud. Under these circumstances, plaintiff need only show causation in fact; in order to do so plaintiff should have the opportunity to prove, *but is not required to prove,* that it saw or directly relied upon, the financial statements certified by the accounting defendants. (Emphasis added) 516 F.2d at 814

In the very recent case of *Panzirer* v. *Wolf,* ____ F.2d ____ (2nd Cir. 1981) (2nd Cir., Docket 80-7827, Oct. 23, 1981)[19] the Second Circuit, without citing *Shores* v. *Sklar,* reached a similar result. The plaintiff in *Panzirer* alleged that she purchased stock in reliance on an article in the Wall Street Journal and that this

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[19] A full copy of this opinion is attached hereto as an Appendix for the convenience of the Court.

article would have been less favorable if the true financial condition of the company had been stated in the annual report of the company. The company thereafter went into bankruptcy. Plaintiff brought a Rule 10b-5 action against the officers of the company and the accountants who prepared the annual report. *The plaintiff never saw the annual report.*

> "The function of requiring the plaintiff to show reliance in a 10b-5 action is to permit only those injured by fraud to sue. If plaintiff can link her injury to defendant's fraud by showing the fraud was a 'substantial' or 'significant' contributing cause; plaintiff has shown sufficient reliance to support her 10b-5 claim. [citation omitted] Plaintiff has on this record stated a sufficient connection between her loss and the allegedly fraudulent annual report to withstand a motion for summary judgment."
>
> * * *
>
> "....Proving reliance is necessarily difficult where the fraud has affected the market and damaged the plaintiff only through its effect on the market. Relying on *Affiliated Ute,* this and other circuits do not require direct reliance where the fraud effects the market, on the ground that an investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected the price." (App. A-4, A-6)

In *Blackie* v. *Barrack,* 524 F.2d 891 (9th Cir. 1975), the Ninth Circuit held that a purchaser of a security may rely on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price. The following language of the *Blackie* court states the holding and clearly shows that the claim in the *Shores* v. *Sklar* dissenting opinion that *Blackie* "provides absolutely no support" for the majority[20] is in error:

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[20] 647 F.2d at 479

Here, we eliminate the requirement that plaintiffs prove reliance directly in this context because the requirement imposes an unreasonable and irrelevant evidentiary burden. A purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it; he may purchase because of a favorable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price-whether he is aware of it or not, the price he pays reflects material misrepresentations. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact that the causational chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation. We decline to leave such open market purchasers unprotected. The statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely. 524 F.2d at 907

**No Conflict With Other Circuits**

The *Shores* v. *Sklar* dissent and the petitioners assert that the opinion is directly contrary to the case of *Vervaecke* v. *Chiles, Heider & Co., Inc.*, 578 F.2d 713 (8th Cir. 1978). The petitioners[21] and the dissenting opinion[22] tell us that the Eighth Circuit in *Vervaecke* "expressly rejected *Vervaecke's* argument that

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[21] Petition for Writ, p. 7-8

[22] 647 F.2d at 477

his attempt to cast his complaint under subsections (1) and (3) of the rule excused the reliance requirement."[23]

Vervaecke did not allege or argue a "fraud on the market" theory. He limited his complaint and his arguments to a claim that his was a nondisclosure case rather than a misrepresentation case.[24] The court specifically recognized that there were other theories available in the case to Vervaecke which he failed to assert.

> Though other theories of this case might have been devised, we find that the thrust of what Vervaecke actually pleaded was the use of fraudulent misstatement and omission within the four corners of an offering prospectus which mislead *him* and other bond purchasers; we share this understanding of the complaint with the district court. (Emphasis original) 578 F.2d at 718

The *Vervaecke* court was not presented with a "fraud on the market" theory though the foregoing language recognizes such a theory, had it been argued, may have saved Vervaecke's case. The court's holding that *Vervaecke* failed to establish a nondisclosure case was based on the allegations in the complaint which were argued on appeal, though the court pointed out a portion of the complaint which may have altered its opinion had it been argued on appeal.[25] This part of the complaint alleges that some of the defendants represented to members of the proposed class that they should purchase the stock without any reasonable basis for such recommendations. The *Vervaecke* court is clearly saying that this allegation may have raised the "fraud on the market" theory and saved Vervaecke's case if it had been argued.

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[23] Petition for Writ, p. 9

[24] 578 F.2d at 717

[25] Id. at Footnote 3

The foregoing analysis leads to the conclusion that the Fifth Circuit has merely adopted a limited "fraud on the market" theory in this case and that it has done so after careful consideration following a rehearing *en banc*. Counsel have twice briefed and argued this case before the Fifth Circuit, arguing the meaning and effect of all relevant authorities. This Court should not review this case on the basis that it constitutes a departure from applicable precedents or is in conflict with decisions from other circuits.

**Opinion Is Consistent With Proper Construction Of Rule 10b-5**

The petitioners further argue that the *Shores* v. *Sklar* opinion permits recovery by plaintiffs who were not deceived and thus not defrauded. In fact, petitioners argue that this case will transform the emphasis of Rule 10b-5 "from an antifraud statute to an insurance scheme."[26]

This contention is difficult to understand in view of the holding in *Shores* v. *Sklar* that the plaintiff may only recover if he can establish the requisite element of causation by proving that the alleged scheme was intended to and did bring the bonds onto the market fraudulently and that he relied on the integrity of the offerings of the securities market in making the purchase of the bonds. A plaintiff required to meet these burdens of proof can hardly be a beneficiary of investors insurance. The exact language of the court setting out plaintiff's required burden of proof is as follows:

> Bishop's burden of proof will be to show that (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) Bishop *relied* on the Bonds' availability on the market as an indication of their

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[26] Petition for Writ, p. 7

> apparent genuineness, and (3) as a result of the scheme to defraud, he suffered a loss. (Emphasis added) 647 F. 2d at 469

Furthermore, *Shores* v. *Sklar,* unlike the Second and Ninth Circuit cases, requires the plaintiff to prove that the bonds could not have been marketed *at all* but for the fraud. Proof that the fraud merely affected the price or the rate at which they were offered will be insufficient:

> If Bishop proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, *he cannot recover.* Thus, a purchaser of securities will still have the *strongest incentive* to read the disclosure statement if he wants to ensure he gets full value for his securities purchases. (Emphasis added) 647 F.2d at 470.

These strict requirements of proof in order for the essential element of causation to be established by the plaintiff certainly refute any effort to claim *Shores* v. *Sklar* replaces Rule 10b-5 as an antifraud statute with a scheme of investors insurance.

Moreover, the petitioners' arguments that investors will no longer read offering material is refuted by the above statement from the majority opinion pointing out the obvious fact that investors who want to get full value for their money will have the "strongest incentive" to read such materials.

The petitioners' argument that the opinion in *Shores* v. *Sklar* somehow violates the principles enunciated by this Court in *Santa Fe Industries* v. *Green,* 430 U.S. 462 (1977) is simply without merit.[37] Petitioners argue that *Santa Fe* teaches that

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[37] Id. at pp. 9-10

violations of Rule 10b-5 require "manipulation" and "deception" and that *Shores* v. *Sklar* eliminates such concepts.[28]

The circuit court below held that the plaintiff alleged "deception" in that he *relied* on the "integrity of the market" in making his investment decision and that the fraudulent actions of the defendant adversly affected that integrity, thus causing his loss.[29] The circuit court also specifically held that the scheme was "manipulative" as it must be under the teachings of the *Santa Fe* case.[30] The *Santa Fe* case does not state a single principle that is inconsistent with the lower court opinion in the instant case.

The petitioners' argument that the opinion of the court below cannot be analogized to the "fraud on the market" theory[31] can be refuted by the petitioners' cited authorities. The petitioners list a number of law review articles as "scholarly articles written about the reliance requirement."[32] One of these articles, Note, *The Reliance Requirement in Private Actions Under SEC Rule10b-5,* 88 Harv. L. Rev. 584 (1975), is worth a thorough reading, particularly pages 592-596. This article, in discussing "Deception Affecting the Market," states as follows:

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[28] Petitioners state:

"... The holding of the circuit court below that Bishop (plaintiff) can state a cause of action without alleging that the defendants deceived him in making his investment decision is manifestly contrary to the *Santa Fe principle.*" *Id. at p. 10*

[29] 647 F.2d at 469-470

[30] "8. The schemes must, of course, be one within the "manipulative" condemnation of the securities law. (*citing Santa Fe*) This one clearly is." 647 F.2d at 470, n 8

[31] Petition for Writ, Footnote 7, pg. 5

[32] Id., footnote 9, pg. 9

[33] Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 Harv. L. Rev. 584, at 592 (1975).

> Although *Affiliated Ute* emphasized the nondisclosure aspects of that case, the case of a plaintiff damaged by the effect of a deception on the open market may also justify a presumption of reliance once the materiality of the deceptive practice is established. When a deception allegedly caused damage by means of its impersonal effect on a securities market, proof of causation requires showing that the deception affected the market and that damage to the plaintiff resulted. *The concept of plaintiff's own reliance is totally unrelated to either link of the causal chain.* As Professor Bromberg has pointed out, a person who trades during the period in question may be harmed by a deception that affects prices and conditions in the relevant market, regardless of whether he has relied on *or even heard the deception.* (Emphasis added)[33]

The petitioners have represented to this Court that the foregoing is from a scholarly consideration of the role or reliance in Rule 10b-5 actions. The clear support of this article for the opinion in *Shores* v. *Sklar* is, therefore, most persuasive.

**Opinion Does Not Create Federal Government Guarantee of Quality of Securities**

The final argument of the petitioners is that somehow *Shores* v. *Sklar* violates the stated Congressional policy that the federal securities laws are not intended to insure that all securities will be guaranteed to be of any particular quality by the United States Government. In support of this argument petitioners quote language from The House Committee Report on the Securities Act[34] and the corresponding Senate Committee.[35] The language quoted is inapplicable because it relates solely to securities which are required to be registered with the Securities

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[34] Petition for Writ, p. 13

[35] Id. at p. 14

and Exchange Commission and the bonds in this case are not of that type of security. The Congress obviously did not want to put the burden on the Commission to act as an insurer of the quality of the securities registered with it before issuance.

The question in this case is not the effect of registering securities with the Securities and Exchange Commission before their sale to the public. The question here is whether a plaintiff may recover *from the wrongdoers and not the United States Government* in a Rule 10b-5 action for losses caused by purchasing securities placed on the market solely as a result of a fraudulent scheme to defraud investors in those securities. The assumption of any guarantee of the quality of securities by the federal government has nothing to do with this case.

## CONCLUSION

This case is not one that should be reviewed by this Court. This case involves no more than an adoption by the Fifth Circuit of a limited version of the "fraud on the market" theory in Rule 10b-5 cases.

Respectfully submitted,

W. Eugene Rutledge
RUTLEDGE AND YEAROUT
1020 First Alabama Bank Building
Birmingham, Alabama 35203
205/322-8761
Attorney for Respondent

## APPENDIX

Zelda L. Panzirer,
Plaintiff-Appellant,

v.

Emanuel L. Wolf, Jay N. Feldman, C. Ray Holloway,
William V. Lurie, Carl Prager, Julio Proietto,
Jack M. Sattinger and Price Waterhouse & Co.,
Defendants-Appellees.

No. 10, Docket 80-7827

United States Court of Appeals,
Second Circuit.

Argued September 16, 1981.
Decided October 28, 1981.

Allied Artists Industries, Inc. issued an allegedly false annual report in August 1978. Zelda Panzirer purchased Allied stock thereafter upon reading an article in the Wall Street Journal. She never saw the annual report. When Allied started bankruptcy proceedings in 1979, she sued Allied officers and Price Waterhouse & Co., Allied's accountants, under Sec. 10(b) and Rule 10b-5 of the Exchange Act, 15 U.S.C. Sec. 78j(b), 17 D.F.R. Sec. 240, 10b-5. She also sought to represent the class of investors purchasing Allied stock after release of the annual report. The district court, per Motley, J., dismissed Zelda Panzirer's suit on summary judgment and denied class certification on the ground that she had failed to show that reliance on the annual report caused her loss. We reverse in part and affirm in part. Plaintiff relied on the article in the Wall street Journal which she claims would have presented the company in a less favorable light had the annual report been accurate. She has stated a causal connection between her loss and the annual

report which, on this record, cannot be dismissed on summary judgment. We affirm, however, the denial of class certification as being within the discretion of the district court.

On this appeal from summary judgment, the allegations of the complaint, as supplemented by plaitniff's deposition and numerous affidavits submitted by all parties, describe the story of Zelda Panzirer's losing investment in Allied common stock. She read about Allied in the Wall Street Journal while driving up to Vermont on September 29, 1978. The "Heard on the Street" column in that day's Journal covered the video cassette market, and devoted two paragraphs to Allied:

> Several analysts contend that Allied Artists is in a good position to take advantage of the growing demand for video tapes, having pioneered the development of pre-recorded cassettes.
>
> Andrew G. Racz of Philips, Appel & Walden, Inc. says Allied Artists, besides having a head start in video tapes and cassettes, is negotiating with TV networks, other firm producers and makers of educational films to put their films on video cassettes. "The educational and informational area constitutes a tremendous market for video cassettes," says Mr. Racz, adding: "We continue to be bullish on Allied Artists. It's an attractive turn-around situation."

Zelda Panzirer had been a substitute school teacher. The item on the educational use of video cassettes caught her eye. She checked the price of Allied common stock, which was listed on the American Stock Exchange and had traded at between $5 and $6 1/8 on September 28. Her husband Leo Panzirer stopped the car. Zelda Panzirer called her broker, Michael Blue, at E.F. Hutton's office in Hackensack, N.J. She asked if there was any negative news about Allied. Blue said that neither he nor E.F. Hutton followed the company, but after several minutes delay

and a glance at Standard & Poor's tear sheet on Allied, said there was no negative news. Zelda Panzirer ordered 200 shares of Allied common stock. Later on her trip, after discussing the purchase with her husband, she phoned Blum a second time to raise her order to 500 shares. E. F. Hutton purchased the shares for Zelda Panzirer at a September 29 market price of $7 per share.

The Standard & Poor's tear sheet abstracted information from Allied's annual report for the fiscal year ended March 31, 1978. The report was issued on August 18, 1978 and allegedly contained numerous misrepresentations and omissions. The principal misrepresentation was the report of profits for that year based in part on receipts from Allied's film, "The Betsy." In fact, Allied had to split those receipts with the film's overseas distributor, United Artists, and thus lost money in 1978. The principal omission was the annual report's failure to include a qualification by Allied's accountants stating their doubts as to Allied's ability to function as a going concern. Allied common stock closed at $27/8 per share the day the annual report was issued. It peaked at $73/8 per share on October 2, 1978, and declined thereafter. Allied filed a Chapter XI petition in backruptcy on April 4, 1979.

Plaintiff's amended complaint alleges that Price Waterhouse originally included in its certification of Allied's statements a qualification as to Allied's ability to function as a going concern. The complaint alleges that the qualification was removed from the certification before the annual report was published.

The annual report was not mailed to Allied shareholders until Friday, September 8, on which date Allied common stock closed at $31/8. Allied's entry into the video cassette market was announced on Saturday, September 9. Whether the subsequent appreciation in price was due to the annual report or to Allied's entry into the video cassette market is irrelevant to our decision, as we do not depend on Zelda Panzirer's knowledge of the

market price. Though Michael Blum stated in his affidavit that he mentioned the activity of Allied common to plaintiff, she nowhere refers to the stock's activity as a reason for her purchase.

Zelda Panzirer never saw the annual report. In her complaint, she alleges that she relied on the "integrity of the market." She asserts that the annual report affected the market, and therefore she had relied on the report through her reliance on the integrity of the market. Judge Motley, however, found that plaintiff "primarily" relied on the Wall Street Journal column about Allied's prospects in the video cassette market and that plaintiff placed only secondary reliance on the integrity of the market. She held that secondary reliance was insufficient to support a 10b-5 claim. We cannot agree. We find no support in the law for the district court's distinction between primary and secondary reliance.

The function of requiring the plaintiff to show reliance in a 10b-5 action is to permit only those injured by fraud to sue. If plaintiff can link her injury to defendant's fraud by showing the fraud was a "substantial" or "significant contributing cause," plaintiff has shown sufficient reliance to support her 10b-5 claim. *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981). Plaintiff has on this record stated a sufficient connection between her loss and the allegedly fraudulent annual report to withstand a motion for summary judgment.

As we read the record, Zelda Panzirer's purchase of the Allied stock was caused by her perusal of the Wall Street Journal column. Her knowledge of the price of the stock and her conversation with her broker were merely neutral factors as they presented no impediment to her acting on the favorable notice in The Wall Street Journal. Consequently, the plaintiff argues that if Allied's report had been accurate, the stock analysts in-

terviewed by the Journal would not have mentioned the Company favorably, the Journal would not have devoted two paragraphs to Allied's prospects in the video cassette market, and plaintiff would not have been led by the article to buy her stock. Defendants have introduced no evidence to contradict this chain of causation. Though, at trial, the validity of the chain of causation will be tested, on summary judgment questions about this chain of causation must be resolved in favor of plaintiff, who in the case of material fraud on the market enjoys a presumption of reliance. Where the plaintiff acts upon information from those working in or reporting on the securities markets, and where that information is circulated after a material misrepresentation or omission, plaintiff has stated a sufficient claim of reliance on the misrepresentation or omission.

Plaintiff refers to the price of Allied common stock once in her depositions: "If the price was outrageous, something very high, I wouldn't have been interested. The price was attractive." If anything, her testimony indicates that a lower price accurately reflecting Allied's true financial position might have led her to buy more stock.

Our holding is supported by *Competitive Associates, Inc.* v. *Leventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811 (2d Cir. 1976). In that case, investment manager Akiyoshi Yamada mishandled a Competitive Associates' investment fund. Yamada had previously mishandled another investment fund, but his earlier mistakes had been hidden by allegedly false financial statements certified by the defendant accountants. The district court granted summary judgment to defendants on the ground that because Competitive Associates did not see the financial statements it could not prove reliance on them. We reversed, holding that Competitive Associates need not prove direct reliance, but only causation in fact. That is all Zelda Panzirer need show here. As in Competitive Associates, the fact that plaintiff must trace her reliance on defendant's alleged fraud through the reactions of third parties does not vitiate her claim under 10b-5.

Where, as is here alleged, the fraud consists of a failure to disclose, the difficult nature of plaintiff's claim that if there had been disclosure, plaintiff would not have been harmed had led the Supreme Court to hold that if the omission is material, reliance upon the omission will be presumed. *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972). Proving reliance is necessarily difficult where the fraud has affected the market and damaged the plaintiff only through its effect on the market. Relying on Affiliated Ute, this and other circuits do not require direct reliance where the fraud affects the market, on the ground that an investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected that price. See *Ross* v. *A. H. Robins Co.,* 607 F.2d 545, 554 (2d Cir. 1979), cert. denied, 447 U.S. 946, 100 S.Ct. 2175, 64 L.Ed.2d 802 (1980); *Blackie* v. *Barrack,* 524 F.2d 891, 906-07 (9th Cir. 1975), cert. denied, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976). As in Affiliated Ute, Blackie held that the materiality of a fraud creates a presumption of reliance through its presumed effect on the market. See also Note, The Reliance Requirement in Privat Actions Under SEC Rule 10b-5, 88 Harv. L.Rev. 589 (1975).

Our holding is no more than an extension of Blackie. Zelda Panzirer did not rely on the integrity of the market price because she did not rely on price, but she did rely on the integrity of the market in producing the information reported in The Wall Street Journal. Just as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information "heard on the street" which led Zelda Panzirer to make her losing investment.

Merely because Zelda Panzirer's own claim survives summary judgment, however does not make her fit to represent a class of Allied investors. Plaintiff appeals from Judge Motley's denial of class certification. Judge Motely ruled that the weakness of

plaintiff's case concerning reliance made her claim atypical under Fed.R.Civ.P. 23(a)(3), and also ruled that plaintiff's lack of credibility made her an inadequate class representative under Fed.R.Civ.P. 23(a)(4). We affirm on the latter ground. Plaintiff's lack of credibility is abundantly clear in the record. She gave no less than four versions of her conversation with her broker. At her deposition, she described the conversation as containing no specific information about Allied. Before signing her deposition, she changed her story to say that Michael Blum had read unspecified information to her from his Standard & Poor's tear sheet. In her affidavit explaining her changes in testimony, she allged that he had told her that Allied had made money in 1978. After defendants introduced an affidavit from the broker that he had never looked at the financial information on Allied in the tear sheet, Zelda Panzirer introduced a final affidavit alleging that he had read financial information to her from the tear sheet. The credibility of a plaintiff may be considered by the trial judge in determining the plaintiff's adequacy as a class representative. *Kline* v. *Wolf,* 88 F.R.D. 696, 699-700 (S.D.N.Y. 1981); C. Wright & A. Miller, Federal Practice and Procedure Sec. 1766 at 632-34. Judge Motely acted well within her discretion in concluding that Zelda Panzirer's lack of credibility rendered her an inadequate class representative.

We do not decide whether Zelda Panzirer's weak showing of reliance makes her claim atypical under F.R.Civ.P. 23(a)(3), as we find her numerous changes in her testimony sufficient reason to deny class certification.

Affirmed in part, reversed in part, remanded for proceedings consistent with this opinion.

# Petitioner's Reply Brief

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

JERALD H. SKLAR, *et al.*,
*Petitioners,*

v.

JAMES L. SHORES, JR., Executor of the Estate of Clarence E. Bishop, Jr.,
*Respondent.*

## PETITIONERS' REPLY BRIEF

CRAWFORD S. MCGIVAREN, JR.
LARRY BRITTAIN CHILDS
CABANISS, JOHNSTON, GARDNER, DUMAS & O'NEAL
1900 First National-Southern Natural Building
Birmingham, Alabama 35203
(205) 252-8800

*Attorneys for Petitioners Jerald H. Sklar, Allen Cox, Jr., Roane Waring, Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr.*

February 8, 1982

*(Additional Attorneys Listed Inside Front Cover)*

St. Louis Law Printing Co., Inc., 411 No. Tenth Street 63101 314-231-4477

HOBART A. MCWHORTER, JR.
SAMUEL H. FRANKLIN
BRADLEY, ARANT, ROSE
& WHITE
1400 Park Place Tower
Birmingham, Alabama 35203
(205) 252-4500

*Attorneys for Petitioner Capell, Howard, Knabe & Cobbs, P.C.*

HENRY E. SIMPSON
LANGE, SIMPSON, ROBINSON
& SOMERVILLE
1700 First Alabama Bank Building
Birmingham, Alabama 35203
(205) 252-7000

*Attorney for Petitioner First Alabama Bank of Phenix City, N.A.*

JAMES L. NORTH
NORTH, HASKELL, SLAUGHTER
YOUNG & LEWIS
1710 First National-Southern
Natural Building
Birmingham, Alabama 35203
(205) 252-8847

*Attorneys for Petitioners Cecil Lamberson and Jackson Municipals, Inc.*

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# No. 81-839

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

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JERALD H. SKLAR, *et al.*,
*Petitioners,*

v.

JAMES L. SHORES, JR., Executor of the Estate of
Clarence E. Bishop, Jr.,
*Respondent.*

---

## PETITIONERS' REPLY BRIEF

### FRAUD ON THE MARKET

Contrary to respondent's facile suggestion, the Fifth Circuit's majority opinion in this case does not simply recognize a "limited 'fraud on the market' theory of recovery."[1] The majority's opinion fundamentally and substantially expands Rule 10b-5, in conflict with all precedent, including so-called "fraud on the market" cases. The lower court's abandonment of reliance and recognition of a substantive guarantee of quality to purchasers are plainly unsupported by any prior decision.

Even those courts that have embraced a "fraud on the market" theory have not eliminated the reliance requirement;

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[1] Brief in Response to Petition For a Writ of Certiorari at 5.

rather, each has invoked a *rebuttable presumption* of reliance.[2] Here, expressly finding that any presumption of reliance had been rebutted, the majority *abandoned* the reliance requirement.[3]

Such expansion of liability beyond the pale of prior "fraud on the market" cases is most significant. Not only does elimination of reliance violate this Court's instructions pertaining to judicially implied remedies;[4] it also contravenes clearly expressed Congressional intent, as manifested in the 1934 Act's legislative history, which is quoted in the Petition[5] and ignored in respondent's brief.

The so-called "fraud on the market" cases assuredly provide no analytical or precedential support for the majority's substantive guarantee to purchasers that all securities will be of

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[2] Referring to the seminal "fraud on the market" case, *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), the dissent below commented that "*Blackie's* significance to the case at bar rests in its holding that despite a presumption of reliance in "fraud on the market" cases, the defendant may still defeat recovery by positive proof of non-reliance. The Ninth Circuit has consistently adhered to this rule. *E.g.*, *Keirnan* v. *Homeland, Inc.*, 611 F.2d 785, 788-89 (9th Cir. 1980" (A-33-34).

Similarly, the principal issue in *Panzirer* v. *Wolf*, 663 F.2d 365 (2d Cir. 1981), reproduced in the appendix to respondent's brief, was whether the presumption had been rebutted.

[3] Though the majority opinion speaks of Bishop's "relying" upon the "integrity of the market", the opinion clearly acknowledges abandonment of the requirement of reliance, as traditionally recognized and applied. *See* A-10-11, quoted in Petition at 4-5.

The dissent correctly concluded that "[t]hus, *Blackie* provides absolutely no support for the majority's partial abandonment of the reliance requirement." (A-34).

[4] See Petition at 10-12.

[5] See Petition at 11, n. 12.

"market risk" quality. The lower court's recognition of a distinction between securities "entitled to be marketed" and those "not entitled to be marketed" has radical implications for the administration of Rule 10b-5.[6]

Whether or not it should be viable in other contexts,[7] the "fraud on the market" theory, as embraced by the Second and Ninth Circuits, is fundamentally inapplicable to this case. The most rudimentary requirement of the "fraud on the market" theory is a purchase in the *open market.* As explained by the Ninth Circuit, the "fraud on the market" concept was expressly intended to apply "in the impersonal stock exchange context."[8] The record is clear that Bishop purchased in personal, face to face transactions with his seller, during the primary offering of the securities. The theoretical premises of the "fraud on the market" theory simply do not apply to a purchase outside an impersonal exchange context.

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[6] The majority's departure from the long standing policy against governmental assurance of the soundness of any security is especially incongruous. As respondent's brief mentioned, these bonds were not subject to registration. Thus, in the total absence of even analogical support, the court below undertook to bestow its guarantee of quality to primary purchasers of unregistered securities. In stark contrast, Congress not only eschewed, but expressly prohibited extension of such assurances, even to purchasers of securities subject to the meticulous requirements of registration.

Respondent's suggestion that the policy against governmental assurance of quality is limited to the Securities Act of 1933, Brief in Response at 16-17, simply ignores the statement of Congressional intent for the 1934 Act, which is quoted in the text of the Petition at 14.

[7] This Court has never addressed the "fraud on the market" theory.

[8] *See Blackie* v. *Barrack, supra,* 525 F.2d at 906. Referring to "purchaser[s] on the stock exchanges," the Ninth Circuit declared, "We decline to leave such *open market purchasers* unprotected." *Id.* at 907 (emphasis added). *See* Note, *The Reliance Requirement* in Private Actions Under SEC Rule 10b-5, 88 HARV. L. REV. 584 (1975), quoted in Brief in Response at 16.

Finally, respondent's attempt to compare the Fifth Circuit's holding to prior "fraud on the market" cases does not dispel the conflict among the circuits. It illustrates further division.[9] Clearly, Bishop could not state a cause of action under *Blackie* or *Panzirer,* because the court below acknowledged that any *presumption* of reliance upon defendants' statements was rebutted by his affirmative admission of non-reliance. (A-11.) Likewise, the plaintiffs in *Blackie* and *Panzirer* could not prevail under the lower court's holding because they could not claim that the securities there involved could not have been sold at any price, but for the claimed fraud. Thus, examination of "fraud on the market" cases reveals additional conflict among the circuits and disparate administration of the federal securities laws.

## CONFLICT WITH VERVAECKE AND SANTA FE

Respondent's brief concedes, as it must, that this case *on its facts* is virtually identical to *Vervaecke* v. *Chiles, Heider & Co.,* 578 F.2d 713 (8th Cir. 1978), and that the results reached are diametrically opposite. Indeed, respondent asserts that the only difference is that Vervaecke did not argue the "fraud on the market" theory. Simply by artful reference to the talismanic phrase "fraud on the market" respondent seeks to displace well-settled principles of the law of Rule 10b-5, and pursue recovery where courts in identical circumstances have held there could be no recovery.

Contrary to respondent's suggestion, the result in *Vervaecke* did not turn on the mere fortuity of plaintiff's overlooking the right argument. The *Vervaecke* court expressly refused to allow the legal theory that plaintiff chose to argue to obscure the dispositive point that *on the facts alleged,* Vervaecke's complaint was insufficient because of his inability to establish reliance.

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[9] Respondent's argument that the majority's holding is "more limited" than *Blackie* and *Panzirer,* concedes a conflict.

The *Vervaecke* opinion also indicated that had Vervaecke avoided the requirement of affirmatively alleging reliance, he, at most, would have been entitled to a presumption of reliance. Since the Fifth Circuit below conceded that any presumption had been rebutted, the irreconciliable conflict between *Vervaecke* and this case is undeniable.

The previously demonstrated conflict between the holding of the court below and that of *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977), stands unanswered. The majority's premise, repeated in respondent's brief,[10] that this case involves "manipulation," is plainly erroneous. As this Court has carefully explained, manipulation "is virtually a term of art when used in connection with securities markets," referring to artificial trading by issuers designed to simulate market activity. *See Santa Fe, supra,* 430 U.S. at 476-77; *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 204-05 (1976). This case manifestly involves no allegations of such trading by any of the defendants.

The majority's elimination of reliance leaves the 10b-5 cause of action bereft of the single element necesary for a plaintiff to satisfy *Santa Fe's* deception requirement. As respondent's equivocal assertion that defendants "caused his loss" by "adversely affect[ing]" the "integrity of the market" shows, respondent cannot establish the basic premise that *petitioners deceived him,* as required by *Santa Fe's* and the common law of fraud. In sum, proof of reliance is essential to proof of deception. The Fifth Circuit's basic alteration of the law of fraud should be reviewed by this Court.

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[10] Brief in response at 14-15.

## CONCLUSION

For the reasons stated in the Petition, a writ of certiorari should issue.

CRAWFORD S. McGIVAREN, JR.
LARRY BRITTAIN CHILDS
Cabaniss, Johnston, Gardner,
Dumas & O'Neal
1900 First National-Southern
Natural Building
Birmingham, Alabama 35203

Attorneys for Petitioners Jerald H. Sklar, Allen Cox, Jr., Roane Waring, Jr., Erich James, Robert L. Cox, Louis F. Allen and Frank L. Watson, Jr.

HOBART A. McWHORTER, JR.
SAMUEL H. FRANKLIN
Bradley, Arant, Rose & White
1400 Park Place Tower
Birmingham, Alabama 35203

Attorneys for Petitioner Capell, Howard, Knabe & Cobbs, P.C.

HENRY E. SIMPSON
Lange, Simpson, Robinson
& Somerville
1700 First Alabama Bank Bldg.
Birmingham, Alabama 35203

Attorney for Petitioner First Alabama Bank of Phenix City, N.A.

JAMES L. NORTH
North, Haskell, Slaughter,
Young & Lewis
1710 First National-Southern
Natural Building
Birmingham, Alabama 35203
(205) 252-8847

Attorney for Petitioners Cecil
Lamberson and Jackson Municipals,
Inc.

February, 1982

# Amicus Brief for the United States

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No. 81-839

# In the Supreme Court of the United States

OCTOBER TERM, 1981

JERALD H. SKLAR, ET AL., PETITIONERS

*v.*

JAMES L. SHORES, JR., EXECUTOR OF THE ESTATE OF CLARENCE E. BISHOP, JR.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

REX E. LEE
*Solicitor General*

JERROLD J. GANZFRIED
*Assistant to the Solicitor General*

*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

EDWARD F. GREENE
*General Counsel*

PAUL GONSON
*Solicitor*

JACOB H. STILLMAN
*Associate General Counsel*

RICHARD A. KIRBY
*Senior Special Counsel*

ROBERT LIPSHER
*Attorney*

*Securities and Exchange Commission*
*Washington, D.C. 20549*

## QUESTIONS PRESENTED

1. Whether a plaintiff in a private damage action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), who purchased securities in an initial public offering and who did not rely on the allegedly false and misleading offering documents may recover, provided that a causal link between the fraud and the harm suffered can be established by other means.

2. Whether the causal link between the fraud and the plaintiff's harm is sufficient when the fraud was so pervasive and integral to the offering that the securities would not have been marketed but for the fraud, and the plaintiff relied on the integrity of the issuing and underwriting process in purchasing the securities.

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---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

### STATEMENT

1. In 1973, the original plaintiff, Clarence E. Bishop, Jr.,[1] purchased in an initial public offering of securities, from or through a broker-dealer, four $1,000 tax-exempt industrial development revenue

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[1] Bishop died after filing suit and the executor of Bishop's estate, respondent James L. Shores, Jr., was substituted as plaintiff by the district court (Pet. 2 n.1).

bonds of the Industrial Development Board of Frisco City, Alabama (Pet. App. B-3, B-4). The bonds were part of an offering by the Board totaling $1,500,000 in face amount and were issued pursuant to an Alabama statute, the Wallace-Cater Act (codified in Ala. Code § 11-54-80 *et seq.* (1975)).[2] Under that statute, the municipality is not liable for any payment on the bonds; rather, the sole source for the payment of interest and repayment of principal is the rent payment made by the lessee of the facility constructed with the proceeds of the bond issue, which payment must be calculated to amortize the principal and interest (Pet. App. A-4, A-5).

The proceeds of the bond issue were used to finance construction of a mobile home manufacturing plant in Frisco City, Alabama. The plant was owned by the Industrial Development Board of that city and leased to a private company. Almost immediately after the plant was constructed and commenced operation, the lessee defaulted on the lease payments, and the bonds went into default. The trustee of the bond issue foreclosed (Pet. App. A-2, A-9, B-3).

Following the default, Bishop brought suit under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, on behalf of himself and a class of all other purchasers of the bonds, against petitioners, who are various persons involved in the issuance of the bonds (Pet. App. A-2, A-10).[3] Bishop

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[2] This statute authorizes a municipality to incorporate an Industrial Development Board to issue tax-exempt bonds (Pet. App. A-4, B-3).

[3] Among others, Bishop sued bond counsel, the underwriter, the certified public accountant and the trustee of the bond issue. The question whether the case may proceed as a class action is still to be resolved (see Pet. App. A-19 to A-20).

alleged that he was the victim of a pervasive scheme to defraud those persons who purchased the bonds; as part of the fraudulent scheme, petitioners allegedly fabricated a materially misleading offering circular to induce the Industrial Development Board to issue and the public to buy the bonds (Pet. App. A-2, A-11).

The court of appeals summarized the facts, viewed in the light most favorable to the plaintiff, as follows. The lessee of the facility in question did not have the financial capability to engage in the manufacture of mobile homes or to pay the rent necessary to amortize the principal and interest on the bonds. Nevertheless, the president of the lessee induced the Town of Frisco City to create an Industrial Development Board to finance the lessee's facility as a scheme to defraud the public. Bond counsel drafted an offering circular, based on information furnished to him by the underwriter and the lessee, but he intentionally or recklessly disregarded other facts of which he was aware. In particular, the offering circular drafted by counsel was misleading in the following respects: (1) it substantially overstated the assets of the lessee by stating that the lessee was the owner of a large parcel of Florida real estate valued at more than $2,200,000, when in fact the lessee had no ownership or equity interest in the property; (2) it falsely described the president of the lessee as a successful and experienced developer of modular home manufacturing plants; and (3) it failed to name the underwriter of the offering or to disclose that the SEC had commenced a civil action for violation of the securities laws against the underwriter (Pet. App. A-5, A-6).

After the Board adopted the resolution approving the bond issue, the underwriter offered the bonds for

sale to the public on the basis of the offering circular, even though the underwriter knew it contained materially false representations and omissions. The trustee of the bond issue, who was responsible for ensuring that the lessee complied with all terms and conditions of the lease, knew or recklessly disregarded the fact that the lessee was in breach of the lease requirement that it maintain a specified minimum working capital. The Board entered into a contract to construct part of the facilities contemplated by the bond issue with a company that served as a vehicle through which a substantial part of the proceeds of the issue was diverted to the benefit of others, including the lessee and its president (Pet. App. A-7, A-8).

Bishop asserted two claims under Rule 10b-5.[4] First, he charged that petitioners violated Rule 10b-5(b), 17 C.F.R. 240.10b-5(b), because false and misleading statements contained in the offering circular were made to the purchasers of the bonds. Second, he

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[4] Rule 10b-5, 17 C.F.R. 240.10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

charged that petitioners violated Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), by engaging in a conspiracy or fraudulent scheme, of which the misleading offering circular was a part, to effect the issuance and public offering of the bonds (Pet. App. A-11, A-13).

In answers to interrogatories, Bishop admitted that he had never seen the allegedly false or misleading offering circular and that he was not even aware of its existence. Bishop purchased the bonds solely upon the basis of the oral representation of his broker that the bonds would be a good investment and that others in the community had purchased such bonds (Pet. App. A-9, B-8).[5]

2. The district court granted summary judgment for petitioners on the ground that Bishop's lack of reliance on defendants' fraudulent statements precluded recovery on any theory of liability (Pet. App. B-10).

On appeal, a panel of the United States Court of Appeals for the Fifth Circuit reversed the district court's decision. *Shores* v. *Sklar*, 610 F.2d 235 (1980). Stating that "the plaintiff's theory is very similar to the fraud-on-the-market theory that has developed in cases involving price-rigging in connection with the sale of stock," the panel concluded that "causation [was] clearly present irrespective of plaintiff's reliance on the Offering Circular," and thus "plaintiff's lack of reliance * * * is irrelevant" (610 F.2d at 239-240). The panel explained that (*id.* at 240):

> Just as the purchaser of a stock on the open market can expect the market to reflect all information about that stock, so, too, can the pur-

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[5] Bishop did not allege that his broker had seen the offering circular (see Pet. 4 n.3). The broker was not named as a defendant (see *ibid.*; Pet. App. B-4).

> chaser of a new bond issue expect [the] procedures [necessary to float a successful bond issue] * * * to have been faithfully performed.

On rehearing en banc, the court of appeals, by a vote of 12 to 10, agreed with the panel that the district court had erred. The majority opinion stated that "[t]o the extent that Bishop pleaded the usual 10b-5 misrepresentation or omission case, the district court was correct" since "[r]eliance is an essential element of such a cause of action" (Pet. App. A-10). Referring to *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), the majority observed that this Court's decision "did not eliminate reliance as an element of a 10b-5 omission case; it merely established a presumption that made it possible for the plaintiffs to meet their burden" (Pet. App. A-10). The court concluded that, "[i]f the *Ute* presumption applie[d] * * *, Bishop's admission [that he never read or otherwise relied on the offering circular] rebuts it" (*id.* at A-11).

Turning to plaintiff's second claim, the court held that even though Bishop had not relied on the offering circular, he could recover under clauses (a) and (c) of Rule 10b-5 if he could prove that the bonds in question were not "entitled to be marketed" (Pet. App. A-13). The majority therefore agreed with the panel that although plaintiff did not rely on the offering circular, causation could be shown if he had "relied on the integrity of the market to furnish securities which were not the product of a fraudulent scheme" (*id.* at A-17). The court stated (*id.* at A-14):

> The requisite element of causation in fact would be established if Bishop proved the scheme was intended to and did bring the Bonds onto the

> market fraudulently and proved he relied on the integrity of the offerings of the securities market. His lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative [citing *Blackie* v. *Barrack*, 524 F.2d 891, 906 (9th Cir. 1975)[6]].

The majority emphasized the limited nature of its holding, stating that in order to recover, Bishop must prove that the security would not have been marketed at all except for the alleged fraud (Pet. App. A-16). In so holding, the court expressly rejected the proposition that Bishop could recover if the fraud had merely affected the price of the security.[7]

## DISCUSSION

The interlocutory ruling of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Moreover, the decision

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[6] The court set forth the elements of Bishop's cause of action as follows (Pet. App. A-14; footnote omitted):

> Bishop's burden of proof will be to show that (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) Bishop reasonably relied on the Bonds' availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud, he suffered a loss.

[7] The court stated (Pet. App. A-16):

> If Bishop proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover. Thus, a purchaser of securities will still have the strongest incentive to read the disclosure statement if he wants to ensure he gets full value for his securities purchases.

appears to turn in substantial part on the facts of this particular case, thus restricting its precedential importance. Accordingly, review by this Court is not warranted.

1. Petitioners argue that the court of appeals erred by permitting plaintiff's suit to proceed notwithstanding his lack of reliance upon the allegedly fraudulent offering circular. While petitioners' argument is not insubstantial, review of that claim by this Court is not necessary at this time.[8]

On two prior occasions, this Court has addressed the basic question whether a plaintiff may recover under the federal securities laws without proving his individual reliance on alleged misstatements. In the situations presented in both those cases, this Court held that, while causation is an essential element, the plaintiff was not required to prove his reliance.

In *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), this Court addressed the issues of reliance and causation in the context of misstatements and omissions made in a proxy statement, in violation of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a), and Rule 14a-9, 17 C.F.R. 240.14a-9. Recognizing that "reliance by [the] thousands of individuals [voting pursuant to the proxy statement]" can scarcely be inquired into, the Court held that there was no need to prove that the deception "ac-

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[8] This Court recently denied review of a similar reliance question when it granted certiorari limited to certain other questions in *Huddleston* v. *Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), cert. granted, Nos. 81-680, 81-1076 (Apr. 5, 1982), limited to the single question presented in the petition in No. 81-680 and to question 1 presented in No. 81-1076. On May 3, 1982, the Court refused to enlarge its grant of certiorari to include the reliance question.

tually had a decisive effect on the voting." 396 U.S. at 382 n.5, 385. Rather, the Court concluded that a sufficient showing of causation is established by proof that "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transactions" (*id.* at 385). This test, the Court stated, "avoid[s] the impracticalities of determining how many votes were affected * * *" (*ibid.*).

In *Affiliated Ute Citizens* v. *United States*, *supra*, the Court, in an action under Rule 10b-5, reversed a lower court decision that held there was no violation of the Rule unless the record disclosed evidence of reliance on the misstatement. The Court concluded that when the fraud involves "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery" (406 U.S. at 153). Citing *Mills*, the Court observed that proof of the withholding of a material fact established the requisite element of causation in fact (*id.* at 154).

In certain factual circumstances, the lower courts have applied the teachings of *Mills* and *Affiliated Ute* to permit recovery whether or not a plaintiff actually relied on the materially false or misleading representation. One such situation is where other persons trading in a securities market have relied on the misstatement, thereby altering the price at which the plaintiff traded.[9] The present case represents an application of this recognized "fraud-on-the-market"

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[9] See, *e.g.*, *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); *Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); *Wachovia Bank & Trust Co.* v. *National Student Marketing Corp.*, 650 F.2d 342, 359 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981).

theory of causation to an initial public offering. The court of appeals' ruling is a narrow one, however, since the court would not permit recovery when the fraud affects only the price of the security. The question here is whether, as the court of appeals held, investors in an initial offering of securities may recover under Section 10(b) based upon fraudulent conduct that is so pervasive and so integral to the offering that the securities would not have been marketed but for the fraud. This has not been a recurring issue. Indeed, it appears that there is only one other appellate decision under Section 10(b) that deals with the applicability of the fraud-on-the-market concept to an initial public offering, and that decision is consistent with the present case.[10] Should a conflict among the circuits develop on this issue at a later time, review by this Court may then be appropriate.

2. Petitioners' claim (Pet. 7-9) that the court of appeals' holding conflicts with the decision of the Eighth Circuit in *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713 (1978), is without merit. In *Vervaecke*, the Eighth Circuit held that the district court had not erred in dismissing the plaintiff's complaint since the plaintiff had not alleged that he relied on a misleading offering circular. However, the plaintiff in *Vervaecke* apparently did not seek to recover under a market fraud theory; he did not allege that his injury resulted from reliance by others on the defendants' misrepresentations or that he himself relied on the integrity of the issuing and underwriting process. Indeed, the Eighth Circuit spe-

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[10] See *Arthur Young & Co.* v. *United States District Court*, 549 F.2d 686 (9th Cir.), cert. denied, 434 U.S. 829 (1977).

cifically recognized that there might have been theories of recovery available to Vervaecke that he failed to assert (578 F.2d at 718; footnote omitted):

> Though other theories of this case might have been devised, we find that the thrust of what Vervaecke actually pleaded was the use of fraudulent misstatement and omission within the four corners of an offering prospectus which mislead *him* and other bond purchasers.

This statement may reflect the court's recognition that a fraud-on-the-market theory, had it been advanced, might have saved Vervaecke's case.

3. Petitioners' claim (Pet. 10) that the decision of the court below is "contrary to the * * * principle" of *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), also is without merit. The present case differs significantly from this Court's decision in *Santa Fe*, a case that was presented to this Court "on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose" (*id.* at 474). Thus, *Santa Fe* involved a situation that this Court viewed as a simple breach of fiduciary duty, and not a "deception" or "manipulation" prohibited by Section 10(b). In contrast, the Fifth Circuit in the present case found that plaintiff had alleged deception in that he relied on the integrity of the offering process in making his investment decision and that the fraudulent actions of defendants created a bond issue that appeared genuine but would never have been sold absent the fraud.

4. The inappropriateness of granting review is highlighted by the atypical nature of the facts of this case, which restricts its precedential importance.

Plaintiff did not allege that either he or his broker relied on or read the allegedly misleading offering circular (see Pet. 4 n.3). It would therefore be impossible for the plaintiff to argue indirect reliance through his broker or other intermediary—*i.e.*, that where an investor relies on an intermediary for investment advice, and the latter in turn relies on the defendant's fraudulent statements in giving that advice, the investor should be permitted to recover as though he himself had relied on the defendant's misleading statements. In those cases where a purchaser in an initial public offering is able to demonstrate such indirect reliance,[11] the court of appeals' theory would be superfluous.

In addition, the securities purchased by the plaintiff in this case were industrial development bonds issued by a municipal authority, which itself may have been defrauded by the lessee company for whose benefit the offering was made. Under the decision below, plaintiff may recover on proof that the municipal authority would not have issued the bonds had it known of the lessee's fraud. Such a situation is less likely to arise in the more typical case where a company makes an offering of its own securities.

5. There is an additional reason why this Court should not exercise its discretion to grant review at this time. The decision of the court of appeals is interlocutory and simply returns the parties to the same position they would have occupied if the district court had denied summary judgment and set the case for trial. If, after remand, discovery is completed and the

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[11] See *Austin* v. *Loftsgaarden*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,628 at 93,106 n.19 (8th Cir. Apr. 7, 1982); *Panzirer* v. *Wolf*, 663 F.2d 365, 367 (2d Cir. 1981).

case is tried on the merits, respondent may be unable to prove all of the elements of his cause of action, thus making the legal question raised in the petition moot.[12] On the other hand, if respondent prevails on the merits, petitioners could then submit not only their present contentions but any additional claims of error that would result from the trial of the case on the merits in a single petition for a writ of certiorari seeking review of a final judgment. In that event, as in other cases remanded for trial, this Court would have the benefit of a full record to assist it in analyzing the issues. In the present procedural posture of this case, however, it is impossible to determine whether the legal question that petitioners seek to litigate will be dispositive, and the question is presented on the basis of hypothetical facts derived from the pleadings and inferences drawn on summary judgment. The interlocutory posture of this case is an independent ground for denial of certiorari. See *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook R.R.*, 389 U.S. 327, 328 (1967) ("because the Court of Appeals remanded the case, it is not yet ripe for review by this Court"); *Hamilton Shoe Co.* v. *Wolf Brothers*, 240 U.S. 251, 257-258 (1916); *American Construction Co.* v. *Jacksonville Ry.*, 148 U.S. 372, 384 (1893).

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[12] For example, respondent may be unable to prove "scienter," as required by *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). See Pet. App. B-4 n.2. If respondent failed to prove scienter, issues of reliance and causation would have no bearing on the outcome of the litigation.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
*Solicitor General*

JERROLD J. GANZFRIED
*Assistant to the Solicitor General*

EDWARD F. GREENE
*General Counsel*

PAUL GONSON
*Solicitor*

JACOB H. STILLMAN
*Associate General Counsel*

RICHARD A. KIRBY
*Senior Special Counsel*

ROBERT LIPSHER
*Attorney*
*Securities and Exchange Commission*

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